

**'EXPENDITURE ACTUALLY INCURRED' AND THE PROBLEM
OF SHARE-BASED PAYMENTS**

by

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Declaration

Research dissertation presented for the approval of Senate in fulfilment of part of the requirements for the Masters in Law in approved courses and a minor dissertation. The other part of the requirement for this qualification was the completion of a programme of courses.

I Theunis Cornelis Claassen (CLSTHE001), hereby declare that I have read and understood the regulations governing the submission of Masters in Law dissertations, including those relating to length and plagiarism, as contained in the rules of this University, and that this dissertation conforms to those regulations.

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Abbreviations and terminology

- i) Income Tax Act (the act) - The Income Tax Act 58 of 1962 (as amended)
- ii) New Companies Act – Companies Act 71 of 2008 (as amended)
- iii) Old Companies Act – Companies Act 61 of 1973 (as amended)
- iv) SARS – South African Revenue Service, as defined in s1 of the Income Tax Act.
- v) SATC – South African Tax Cases Reports (Lexis Nexis)

All references to 'section' or 'the act' pertains to the Income Tax Act 58 of 1962 (as amended), unless otherwise stated.

All references to '*Labat*' pertain to *Comissioner for South African Revenue Service v Labat Africa Ltd* 74 SATC 1 (SCA), unless otherwise stated.

Chapter 1 Introduction

1.1 Background

The use of shares as a method of payment is regarded as a well-established and everyday part of commercial practice. It provides a popular alternative to companies as it requires no actual cash flows. The only cost being the subsequent watering down of existing shareholders rights.

Apart from financing services and assets, it also provides a form of relief for companies facing financial distress or cash flow problems. The company can reach a compromise with creditors, in terms of which existing debt is turned into equity through the issue of shares.¹

Further examples of share-based payments include:² i) Issuing shares as consideration for the acquisition of a going concern. ii) In the discharge of third party debt. iii) Payment to employees for reaching predetermined goals. iv) As part of a share incentive scheme to top management. This provides employees with a direct interest in the company and thus diminishes agency concerns.

Despite the wide application of share-based payments in commerce, the tax implications thereof have always been subject to uncertainty.³ Case law on the question whether share-based payments could be regarded as expenditure was contradictory at best.⁴ Consequently in 2004 the issue was addressed partly by the inclusion of s24B as discussed hereunder at 2.1.2.⁵

¹ See s155(3)(b)(ii) of the Companies Act 71 of 2008 which expressly mentions this possibility as part of business rescue proceedings.

² TE Brincker *Taxation Principles of interest and other financing transactions* 7 ed (2010) at P-2.

³ Ibid.

⁴ See *ITC 1783* 66 SATC 373; *ITC 1801* 68 SATC 57; *ITC 1822* 69 SATC 200 and *Commissioner for South African Revenue Service v Labat Africa Ltd* 72 SATC 75.

⁵ Section 22(1) of the Revenue Laws Amendment Act 32 of 2004.

Section 24B expressly provided that shares issued in the acquisition of assets/trading stock would be regarded as expenditure.⁶ SARS emphasised that by not regarding it as expenditure, this would create a hindrance to company formations and other forms of share financing.⁷ Although s24B provides some certainty, its scope is restricted to the acquisition of assets. As such uncertainty still existed as to shares issued as consideration in circumstances where assets are not acquired, for example for services rendered.

The question was brought to a decisive end with the *Labat* case.⁸ The supreme court of appeal holding that share-based payments would not be regarded as 'expenditure actually incurred'.

As can be expected given the commercial expediency of share-based payments, the finding of Harms AP has consequently given rise to much debate on the meaning of expenditure actually incurred and whether share-based payments meets the mark.

1.2 Aim of study

The aim of this study is to determine what 'expenditure actually incurred' means in the South African tax context. Once this has been established, the researcher will consider the appropriateness of this attributed meaning by engaging with possible arguments for and against the meaning attributed. The study further considers specific phenomena in the sphere of share-based payments such as set-off and recoupment.

1.3 General overview of shares and share-issue.⁹

The scope of the study is restricted to the question of what 'expenditure actually incurred' as contained in the act means. It is however necessary to provide a summary as to the nature of shares and the issue thereof by a company. Reason being that the most contentious issue in dealing with 'expenditure' and as such most of the articles and cases on the question

⁶ Section 24B(1)(a) of the Companies Act 71 of 2008.

⁷ SARS: Explanatory Memorandum on the Revenue Laws Amendment Bill, 2004 at 56.

⁸ *Commissioner for South African Revenue Service v Labat Africa Ltd* 74 SATC 1 (SCA).

⁹ For purposes of the discussion both the old Companies Act 61 of 1973, as well as the new Companies Act 71 of 2008 will be addressed in so far as it is relevant to give context to the question of 'expenditure' as considered.

deal with share-based payments. What follows is a brief outline on all share-based aspects relevant to our discussion.

1.3.1 The legal nature of shares

The Act defines a 'share' as 'one of the units into which proprietary interest in a profit company is divided'.¹⁰ Ownership of assets resides in the company and the shareholder is not entitled by its shareholding to ownership thereof.¹¹ Van Zyl J states in *Cooper v Boyes*:

'The gist thereof is that a share represents an interest in a company, which interest consists of a complex of personal rights which may, as an incorporeal movable entity, be negated or otherwise disposed of. It is certainly not a consumable article, such as money, even though a money value can be placed on it.'¹²

In *Standard Bank of South Africa Ltd and another v Ocean Commodities Inc and others*, the following is stated:

'A share in a company consists of a bundle, or conglomerate, of personal rights entitling the holder thereof to a certain interest in the company, its assets and dividends.'¹³

Shares are not regarded as property until they are issued, at which stage they acquire value in the hands of the shareholder and become moveable property.¹⁴ However it can never be said that the shares constitute property or assets in the hands of the issuing company, neither before nor after issue.¹⁵

Under the old act shares could be issued with or without a par value, being a 'nominal' label of value that attached to the share.¹⁶ If shares had such a par value, they could not be issued at less than that value.¹⁷ *Cassim et al*

¹⁰ Section 1 of 71 of 2008.

¹¹ Farouk HI Cassim (ed), Maleka F Cassim & Rehana Cassim et al *Contemporary Company Law* 2 ed (2012) at 213.

¹² *Cooper v Boyes* 1994 (4) SA 521 (C) at 535.

¹³ *Standard Bank of South Africa Ltd and another v Ocean Commodities Inc and others* 1983 (1) SA 276 (A) at 288.

¹⁴ *Lowry v Consolidated African Selection Trust Ltd* 1940 2 All ER 545 at 565.

¹⁵ R de Swardt 'Do share-based payments made for the procurement of services qualify as expenditure actually incurred?' (2008) *De Jure* 475 at 483.

¹⁶ Section 52(2) of Act 61 of 1973.

¹⁷ Section 81 of Act 61 of 1973.

comments that the par value often tended to be misleading as to the true value of the shares and as such the new act has done away with this distinction between par and no-par shares.¹⁸

1.3.2 Share issue agreement

Shares can be acquired either by purchase from another existing shareholder or through share issue by the company itself.¹⁹ In the latter case the company and subscriber enter into a subscription agreement based on the essentialia of an offer for subscription by the company, application by the subscriber and allocation of shares to the subscriber.²⁰ The contract is completed once shares are paid up and consequently issued.

Payment can take the form of cash or consideration in kind.²¹ It is important to note that the contract is not one of barter as no property is transferred, but rather a conglomerate of personal rights is created i.e. the share.²² It is also not a contract of sale, as the company does not agree to pay a monetary amount nor does it transfer any property to the subscriber.²³

1.3.3 Consideration for shares

If shares are issued at an inadequate consideration, shareholders run the risk that their shareholding becomes watered down.²⁴ To address this risk the concept of capital maintenance existed under the old act. This entailed that 'par shares' could not be issued at less than par, and 'no-par shares' at no less than the average issue price of shares already issued.²⁵ Given the arbitrary nature of the par value in recent times, the new companies act removed this requirement. Existing par value shares, issued before 1

¹⁸ Cassim et al op cit note 11 at 215 read together with s35(2) of Act 71 of 2008.

¹⁹ Celliers, Benade, Henning et al *Corporate Law* 3 ed (2000) at 247.

²⁰ MS Blackman, RD Jooste, GK Everingham et al *Commentary on the Companies Act* (2002) at 241.

²¹ Section 93(2) of Act 61 of 1973, s40(1)(a) of Act 71 of 2008.

²² Blackman et al op cit note 20 at 255 para 5.

²³ De Wet & Van Wyk *Die Suid-Afrikaanse Kontraktereg en Handelsreg* (1992) at 313.

²⁴ Cassim et al op cit note 11 at 226.

²⁵ Sections 81 and 82 of Act 61 of 1973.

May 2011 remains as before, but no new par value shares can be authorised.²⁶

In terms of the s40 of the new act, shares can only be issued for adequate consideration as determined by the board.²⁷ Courts in the past have been reluctant to interfere, unless the consideration was obviously inadequate or evidence of fraud or an absence of bona fide valuation existed.²⁸ This is carried through to the act which stipulates that the adequacy of consideration can only be challenged on the grounds as contained in s76 as read with s77(2). These entail the general fiduciary duties of a director such as avoiding conflict of interest, acting in good faith and the best interest of the company and applying due care, skill and diligence.

Section 40(4) provides that once consideration as discussed above is received, the shares are regarded as fully paid up and are issued by the company. Both acts further provide that no shares may be issued unless fully paid up.²⁹ A share issue agreement will thus be void unless the consideration in cash or kind is received on or before the issue of the shares.³⁰

1.4 Research Methodology

The researcher intends to follow a historic research method. The following sources will be considered in reaching the aims of the study:

- i) South African Legislation
- ii) South African Case Law
- iii) English Case Law
- iv) The opinions of South African authors both in the academic and professional sphere. These include journals, handbooks, newsletters and thesis on the topic.

²⁶ Item 6(2) of schedule 5 of Act 71 of 2008 as read with reg 31(2) of the Companies regulations GNR 351 GG 34239 of 26 April 2011.

²⁷ Act 71 of 2008.

²⁸ *Ooregum Gold Mining Co of India v Roper and Wallroth* 1892 AC 236 (HL) at 136-7.

²⁹ Section 92(1) of Act 61 of 1973 and s40(4) of Act 71 of 2008.

³⁰ *Etkind and others v Hicor Trading Ltd and another* 1998 JOL 1861 (W).

1.5 Structure

1.5.1 Chapter 2: 'Expenditure actually incurred': Areas of application and the continued relevance of the phrase in connection with share-based payments

The chapter firstly considers the application field of the phrase 'expenditure actually incurred' as found in the act. Secondly the effect that ss 24B (as amended) and 11(IA) has had on the relevance of the phrase is considered, where after a conclusion is reached as regards the continued relevance of the phrase in our current tax system.

1.5.2 Chapter 3: Expenditure

The chapter focusses on the meaning of 'expenditure' as found in the phrase 'expenditure actually incurred'. We firstly consider the word 'expenditure' in a general sense by looking at the dictionary meaning attributed and its interpretation. Secondly we consider both South African and English case law on expenditure. Thirdly we look at secondary sources on the meaning of expenditure. Finally we consider if 'loss' adds an extra dimension to the concept of 'expenditure and losses actually incurred'.

1.5.3 Chapter 4: Actually incurred

In this chapter we consider what 'actually incurred' adds to the enquiry of what constitutes expenditure actually incurred. We start by considering the leading South African cases in which 'actually incurred' has been considered. There after we look at the impact if any, that *Labat* has had on this requirement.

1.5.4 Chapter 5: Commentary on *Labat* and the real meaning of 'expenditure actually incurred'

In this chapter we consider the leading arguments raised in connection with *Labat* and share-based payments in general as it pertains to 'expenditure actually incurred'.

1.5.5 Chapter 6: Conclusion

The final chapter provides a brief summary of the conclusions reached in the foregoing chapters. A meaning is attributed to 'expenditure actually incurred' post *Labat* and a conclusion is reached on whether share-based payments conform thereto. We finally consider practical alternatives going forward.

1.5.6 Chapter 7: Bibliography

Chapter 2 ‘Expenditure actually incurred’: Areas of application and the continued relevance of the phrase in connection with share-based payments

2.1 Introduction

In terms of s11(a) of the act, commonly referred to as the general deduction formula, a taxpayer can only deduct from his/her income *expenditure and losses actually incurred* as part of his/her trade, in the production of income, provided that the expenditure and losses are not of a capital nature. (Emphasis added)

Until recently, the question of what constitutes ‘expenditure actually incurred’, was one that evoked relatively little debate. It was traditionally regarded only as a question of timing, namely at what stage could it be said that expenditure was actually incurred, rather than if ‘expenditure’ was actually incurred.³¹ What was required was an unconditional obligation incurred in the relevant year of assessment and if present that was the end of the story.³²

The settled approach was however disregarded in 2011 and a new dimension was added to the question. Harms AP stating as follows:

‘Although the court stated the principle to be deducted from these judgements correctly the problem is that they did not deal with the meaning of ‘expenditure’ but with the question when the expenditure was actually incurred... They held that it was incurred during the tax year in which the obligation arose.... It was never an issue in the instant case as to when liability arose.... The question the court should have posed was whether the issuing of shares by a company amounts to ‘expenditure’ and not whether the undertaking to issue shares amounts to an obligation.’³³

The court held that not only is an unconditional obligation in the year of assessment required, but that the obligation should also constitute

³¹ See *Port Elizabeth Electric Tramway Co Ltd v CIR* 1936 CPD 241, 8 SATC 13; *Concentra (Pty) Ltd v CIR* 1942 CPD 509, 12 SATC 95; *Caltex Oil (SA) Ltd v SIR* 1975 (1) SA 665 (A) and *Nasionale Pers Bpk v KBI* 1986 (3) SA 549 (A).

³² *Nasionale Pers* supra note 31.

³³ *Labat* supra note 8 para 7-8.

‘expenditure’. Thus we can conclude that two requirements flow from the phrase, namely (i) ‘expenditure’ (ii) actually incurred.

What follows in this chapter is firstly a discussion on the relevance of this phrase in South African tax law. Thereafter follows a detailed analysis of the two requirements as interpreted in case law, both from a South African and United Kingdom perspective.³⁴ Finally we look at the *Labat* case and its implications going forward.

³⁴ For purposes of the study the question of what constitutes expenditure in general will be addressed, but due to the nature of case law on the topic a larger emphasis is placed on share-based payments.

2.2 Relevance of the phrase ‘expenditure actually incurred’

The first task is to determine the areas of the act in which ‘expenditure actually incurred’ (hereafter “the phrase”) find application. Thereafter the researcher will look at the working of s24B, s24BA and s40CA of the act and its implications on the relevance of the study. There will also be a brief discussion on s11(IA) as read with s8B.

The phrase finds application in three areas of the act. Firstly it forms part of the general deduction formula as contained in s11(a) of the Act. As such no general deduction is available against income without expenditure or losses being incurred.

Secondly the phrase finds its way into the capital gains regime through para 20 of the Eight Schedule. When calculating capital gains on the sale of an asset the base cost of such an asset is deductible in the calculation. In defining ‘base cost’ para20(1) provides as follows:

‘...the base cost of an asset acquired by a person is the sum of (a) the *expenditure actually incurred* in respect of the cost of acquisition or creation of that asset.’

Further reference to the phrase is found in subsecs (b) and (c) with regard to valuation and related acquisition costs respectively. Consequently no base cost can be deducted from proceeds in terms of part II of schedule eight without expenditure being incurred.

Lastly the phrase finds application in a variety of subsecs of s11.³⁵ These include among others, capital allowances which are only available if expenditure has been incurred in the acquisition of the relevant asset.³⁶

From what is said above it is clear that the phrase forms a central part of deduction regime as found in the act.

³⁵ See ss 11(d) ‘repairs’, 11(g) ‘improvements to fixed property’, 11(gA) ‘patents/inventions’, 11(gB) ‘registration of design/trademark/patent’, 11(gC) ‘acquisition of invention/patent/design/copyright’, 11(gD) ‘gambling/petroleum/telecommunication licence’, 11A ‘expenditure prior to commencement’, 11D(2) ‘research and development’.

³⁶ See *Labat* supra note 8 which dealt with 11(gA).

2.3 The role of s24B/s24BA/s40CA.

As already mentioned the question as to what constitutes ‘expenditure actually incurred’ is particularly significant in the sphere of share-based payments.³⁷ For this reason provisions that explicitly deal with share-based payments impact the relevance of the inquiry.³⁸

Section 24B was inserted in 2004 under the new capital gains regime.³⁹ It provided that where an ‘asset’, as defined in para 1 of schedule 8, was acquired through share issue, certain deeming provisions would apply. Firstly the issuer would be regarded to have acquired the asset at the lower of market value of either the shares issued or asset acquired.⁴⁰ Secondly the seller would be regarded as having received proceeds equal to the market value of the shares upon issue.⁴¹

The section applied to all assets (excluding trading stock) acquired on or after 1 October 2001 and from 24 January 2005 in any other case. As such it was not applicable in *Labat*, as on the facts the relevant asset was already acquired in the 1999 year of assessment.

The explanatory memorandum to s24B states that prior to the enactment of the section, share issues were not regarded as ‘expenditure actually incurred’ in terms of judicial precedent.⁴² This caused a deterrent to company formations and asset acquisition by way of share-financing. The memo states that this was not in line with international tax norms and consequently s24B was enacted to address this hindrance.

In 2012 the commissioner issued a revised memorandum stating that s24B was insufficient as it generally assumes asset-for-share transactions take place on a value-for-value basis.⁴³ As such schemes of uneven value

³⁷ *Labat's Case* supra note 8; *ITC 1783* 66 SATC 373; *ITC 1801* 68 SATC 57 and *Commissioner for South African Revenue Service v Labat Africa Ltd* 72 SATC 75, all dealt with the question whether share-based payments could be regarded as expenditure actually incurred.

³⁸ Sections 42, 45, 47 of the new companies act which provide for corporate rollover relief is not addressed as part of the study.

³⁹ Inserted by s22(1) of the Revenue Laws Amendment Act 32 of 2004.

⁴⁰ Section 24B(1)(a).

⁴¹ Section 24B(1)(b).

⁴² SARS: Explanatory Memorandum on the Revenue Laws Amendment Bill, 2004 at 56.

⁴³ SARS: Explanatory Memorandum on the Taxation Laws Amendment Bill, 2012 at 39.

changes are possible under s24B without the appropriate tax being levied. Further the 'value shifting' definition in par 1 of the eight schedule was inefficient as it only addressed the case of connected persons.

Section 24B has consequently undergone a complete makeover in terms of the Taxation Laws Amendment Act.⁴⁴ As of 1 January 2013, s24B now deals exclusively with share for share issues. The previous s24B as we know it has been moved to s40CA with a number of amendments.

Section 40CA(1) now reads:

'Subject to section 24B, if a company acquires any asset as defined in para 1 of the eight schedule, from any person in exchange for – (a) *shares issued* by that company, that company must be *deemed to have actually incurred an amount of expenditure* in respect of acquisition of that asset which is equal to the market value of the shares immediately after the acquisition; or (b) any amount of *debt issued*... equal to that amount of debt.' (own emphasis)

Thus some marked differences from the old s24B exist. Firstly the value to be placed on the asset as acquired by the issuing company is no longer the lower of the two market values, but rather the market value of the shares. Secondly s40CA now expressly makes provision for the situation where a company acquires an asset through the issue of debt.

The scheme of value shifting has now been directly addressed in terms of s24BA of the act. It provides that where a company acquires assets for consideration in shares issued, and the consideration differs from the consideration that would have applied had the company issued the shares in terms of a transaction between independent persons in an arm's length transaction, the following deeming provisions apply:⁴⁵

subsec(3)(a) *Where market value of the asset exceeds that of shares:* (i) The excess be deemed to be a capital gain in the hands of the issuing company. (ii) Acquirer of shares acquires shares as... (aa) capital asset,

⁴⁴ Taxation Laws Amendment Act No 22 of 2012.

⁴⁵ Section 24BA(4) excludes intra group transactions.

then excess deducted from base cost of asset; (bb) trading stock, then excess deducted from amount taken into account in terms of ss 11(a), 22(1) or 22(2).

subsec(3)(b) *Where the market value of the shares exceeds that of assets:* (i) The excess be deemed a dividend in specie as defined in s64D, paid by company on date of issue. (ii) No adjustment to cost of shares as acquired by seller.

The effect of s24BA is that any value mismatch in an asset-for share transaction will be taxed in the hands of the person receiving the benefit, regardless of whether or not they are connected persons. Section 24BA comes into effect on 1 January 2013 and applies to all transactions entered on or after that date.⁴⁶

The scope of s24B as amended has not altered in its effect on the relevance of our study. Section 40CA now expressly covers cases of share issue for acquisition of assets as defined in para 1 of the eight schedule.

Asset: 'Includes – (a) property of whatever nature, whether moveable or immovable, corporeal or incorporeal, excluding any currency... (b) A right or interest of whatever nature to or in such property.'

It follows that share-based payments are now statutorily deemed 'expenditure actually incurred' when acquiring assets as defined. The researcher contends that the study nevertheless remains relevant as s40CA does not deal with share-based payments as consideration for services rendered or the discharge of pre-existing trade debt.⁴⁷ It further provides a general insight into the meaning of 'expenditure'.⁴⁸

⁴⁶ Section 52(2) of act 22 of 2012.

⁴⁷ See K Burt 'Issuing shares as consideration – Expenditure Actually incurred?' (2004) 18 *Tax Planning* 133 at 136; De Swardt op cit note 15 at 478.

⁴⁸ See E C Jansen van Rensburg 'Some thoughts on the meaning of "expenditure" in the Income Tax Act' (2013) 1 *TSAR* 58 at 59; Editorial 'No-Brainer' (2011) *The Taxpayer* 181 at 182.

Bortz, argues that 'services rendered' could be regarded as an asset by relying on s92 of the old Companies act⁴⁹:

'It is submitted that that since companies are allowed to allot shares to employees, the service that they received, makes those shares fully paid up. In other words, the company *receives payment in the form of services* from the employee. Thus, those services are *clearly an asset in that the company attaches value to such services*'⁵⁰ (emphasis added)

The researcher contends that this is incorrect. Firstly this takes no cognisance of the situation where a company issues shares as consideration for services rendered by a third party. 'Services rendered' implies a service already received, which prior to payment would constitute a liability rather than an asset. It is only where payment is made prior to services being rendered, that there could be argued that the right to receive services (namely the personal right to performance, against the third party in terms of the service contract) could be regarded as an asset.⁵¹

Secondly where the company itself renders services through its employees, the subsequent invoicing of the client upon services being rendered gives rise to a debtor which constitutes an asset in the books of the company, not the potential services to be rendered by employees.

Employees render services in terms of a service contract with employer and the subsequent salary is deductible under s11 as an expense. This undoubtedly does not constitute the acquisition of an asset as defined in para 1. Why should the salary for services rendered, suddenly become an asset because it is paid in shares rather than cash? On the reasoning of Bortz all salaries should now be regarded as an asset as the company places a value thereon. This cannot be intended.

⁴⁹ Jeremy Bortz *Do share-based payments constitute expenditure, for tax purposes, in order to facilitate a deduction?* (Diploma in Income Tax Law dissertation, University of Cape Town, 2006).

⁵⁰ Ibid at 20.

⁵¹ See Jansen van Rensburg op cit note 48 at 69 where she addresses the nature of an asset.

Finally the simple fact that value is received for the issue of shares, does not make the consideration received an asset as defined. This is evident where shares are issued for cash. There is no doubting that the company places value on the cash, but that in itself does not make it an asset in terms of para 1.

2.4 Section 11(IA) as read with s8B.⁵²

The receiver of revenue states in the explanatory memorandum to 11(IA) that 'An employer that directly issues shares to employees is not entitled to any tax deduction for the shares issued because the issue of shares is not viewed as a *cost 'actually incurred'*'.⁵³ (emphasis added)

Given the discouraging effect the above tax treatment has on the transfer of free or discounted shares, and in effect long-term, broad-based employee empowerment, SARS consequently inserted s11(IA) and s8B.

Under s11(IA) provision is made for the deduction of the market value of any qualifying equity shares, as defined in s8B, issued to an employee, less any consideration received from the employee. Provided, that the amount deductible in a single year is restricted to R10 000 per employee per year. The excess can be carried forward to the following year.

'Qualifying equity share' as defined in s8B(3) means an equity share acquired in terms of a broad based employee share plan, and provided that the total value of the equity shares so acquired in that year and the preceding four years do not exceed R50 000.⁵⁴ "Broad-based employee share plan' is further defined in s8B(3), but is not considered in our study.

Thus 11(IA) provides an express deduction for shares issued, given the requirements of s8B is met. The area of application is however narrowly defined and the quantum of deduction is restricted to 10 000 rand a year per employee.

⁵² Inserted by Revenue Law Act 32 of 2004 with effect from 26 October 2004. Section 11(IA) was last amended by 18(1)(e) of Revenue Laws Amendment act no 60 of 2008 which is deemed to be applicable to shares issued on or after 21 February 2008.

⁵³ SARS Explanatory Memorandum op cit note 7 at 6.

⁵⁴ Definition as substituted by s.10(1)(d) of Revenue Laws Amendment act no 60 of 2008.

2.5 Conclusion

In conclusion it is clear that the question as to the meaning of 'expenditure actually incurred' remains relevant. Where s24B and 11(IA) find no application, the question whether shares-based payments constitute expenditure would need to be answered with reference to case law. The study would further provide insight into the meaning of the term 'expenditure' as it applies to tax law today.

Chapter 3 Expenditure

3.1 Introduction

As discussed above the phrase ‘expenditure and losses actually incurred’ finds application in a variety of sections. Traditionally it was interpreted as a whole, constituting one requirement. Recent case law has started to illustrate a distinct second element to ‘actually incurred’ namely ‘expenditure’. The mere incurrence of an obligation is not sufficient, as Harms states in *Labat*:

‘...the term ‘obligation or ‘liability’ and expenditure are not synonyms... the liability or obligation must be discharged by means of expenditure...’⁵⁵

The question therefore is, what does ‘expenditure’ mean in the context of South African taxation?

The term is not defined in the act and in the absence of a definition, courts can avail themselves of a dictionary in determining the ordinary meaning of the word or expression.⁵⁶ In using a dictionary, one should however always remember that it does not provide meaning-in-context. It often provides more than one possible meaning and it is up to the ‘interpreter’ to decide on the most appropriate meaning in context.⁵⁷

Du Plessis warns against an ‘excessive peering at the language without sufficient attention to the contextual scene’ which in turn leads to an unreflective use of a dictionary.⁵⁸

The Oxford dictionary defines ‘expenditure’ as follows: ‘The action of spending funds; an amount of money spent; the use of energy, time, or other resources.’⁵⁹

The ‘Handwoordeboek van die Afrikaanse taal (HAT)’ defines ‘onkoste’ as: ‘Geld vir iets betaal; uitgawes’. ‘Uitgawes’ in turn is defined as ‘Geldbedrag wat uitgegee word; koste’.⁶⁰

⁵⁵ *Labat* supra note 8 para 8.

⁵⁶ Lourens Du Plessis *Re-Interpretation of Statutes* (2002) at 200.

⁵⁷ Ibid.

⁵⁸ Ibid, see also *Jaga v Donges NO* 1950 (4) SA 653 (A) para 664.

⁵⁹ C Soanes & A Stevenson (eds) *Oxford Dictionary of English* 2 ed (2009).

Goldblatt J in applying the above mentioned definition states:

‘Expenditure’ in its ordinary dictionary meaning is the spending of money *or its equivalent eg time or labour* and a resultant *diminution of the assets* of the person incurring such expenditure. (emphasis added)⁶¹

The court thus reads an impoverishment test into the definition, requiring a diminution of assets. The researcher doubts whether this is necessarily implied by the above definition. The Oxford definition makes express provision for expenditure by way of time, energy or other resources. This would include services rendered (energy/time expended by company) and thus be a case where assets are not diminished, but expenditure is nevertheless incurred.

Goldblatt J correctly refers to the the spending of time or labour as constituting expenditure, but then concludes that a diminution of assets is required.

‘Asset’ as considered, was not defined by the court in either *ITC 1783* or *Labat*.⁶² ‘Asset’ has such a variety of meanings, that before a meaning can be established, the scope of the act as a whole needs to be considered.⁶³ Generally speaking, assets are regarded as a person’s patrimonial rights, namely a subjective right to patrimonial objects which that person holds.⁶⁴ It is the claim a person has to legal objects with material or economic value against other persons.⁶⁵ These legal objects include corporeal objects such as land; incorporeal objects such as patent rights and finally personal rights such as the right to performance in terms of a service contract.⁶⁶

⁶⁰ P C Schoonees, C J Swanepoel & S J Du Toit et al *Handwoordeboek van die Afrikaanse Taal* 1 ed (1979).

⁶¹ *ITC 1783* op cit note 4 para 7.2.

⁶² See *Jansen Van Rensburg* op cit note 48 at 73. The author concludes that what would be required on the reading of *Labat*, is a diminution of assets in the legal sense.

⁶³ *Benoni, Brakpan and Springs Board of Executors, Building Society and Trust Co Ltd v Commissioner of Inland Revenue* 1921 TPD 170 at 173.

⁶⁴ C G Van Der Merwe ‘Things’ *LAWSA* vol 27 First Reissue (2001) para 195.

⁶⁵ *Jansen van Rensburg* op cit note 48 at 69; PJ Badenhorst, JM Pienaar & H Mostert *Silberberg and Schoeman’s The Law of Property* 5 ed (2006) at 9.

⁶⁶ L Du Plessis *Inleiding tot die Reg* 3 ed (2003) AT 150; AJ van der Walt & GJ Pienaar *Inleiding tot die sakereg* 5ed (2007) at 8.

Time or labour would not be regarded as an asset as defined above.⁶⁷ As such, no diminution can occur by expending time or labour. One wonders how the conclusion is then made that assets need to be diminished despite the judges view that time or labour expended would be regarded as expenditure. Notwithstanding, the court of appeal also required a movement of assets.

Harms AP in considering the test of Goldblatt J states:

*'In the context of the Act it would also include the disbursement of other assets with a monetary value. Expenditure, accordingly, requires a diminution (even if only temporary) or at the very least movement of assets of the person who expends. This does not mean that the taxpayer will, at the end of the day, be poorer because the value of the counter-performance may be the same or even more than the value expended.'*⁶⁸ (Emphasis added)

From the above it is clear that expenditure does not have to be in money, but can take the form of any asset with monetary value attached thereto. The court also removed the 'diminution' requirement and rather required at the least a movement of assets.

The court using rather clumsy wording required further that a liability be discharged by way of expenditure for it to constitute 'expenditure actually incurred'.⁶⁹ Arguably it was in actual fact trying to convey that one should look at the content of the performance extinguishing the liability.⁷⁰ The liability should be extinguished by way of a movement or diminution of assets, for it to constitute expenditure.

What follows is a look at South African case law on the meaning of 'expenditure' where after cases from the United Kingdom will be considered. Finally we look at secondary sources on the topic.

⁶⁷ See also *Smith v SIR* 1968 (2) SA 480 (A) where the court held that the taxpayer's wits and labour which produced his income were not property.

⁶⁸ *Labat* supra note 8 para 12.

⁶⁹ *Ibid* para 8.

⁷⁰ See Jansen van Rensburg op cit note 48 at 63; C Cilliers 'The Labat decision and the interaction between "expenditure" and the "actually incurred" requirement' (2011) *The Taxpayer* 226 at 228.

3.2 South African Cases dealing with 'expenditure'.

3.2.1 ITC 703⁷¹

This was the first South African case dealing with share-based payments and its deductibility under the then s11(2)(a).⁷² The company sought to deduct an amount, paid by way of share issue, to a firm of consultants for advisory and technical assistance with the erection of a new factory. The main argument on behalf of the commissioner was that the expenditure was capital in nature and thus not deductible.

The court accepted shares issued as constituting payment for purposes of expenditure without further ado. Although the case does not deal expressly with the meaning of expenditure, it nevertheless illustrates a acceptance of share-based payments by our courts.

3.2.2 ITC 1783⁷³

In casu the taxpayer acquired part of the business of the seller including a licence agreement by way of share-based payment. The value of the assets was predetermined and it was agreed that payment would take place by way of share issue at par plus premium. The taxpayer posed to deduct the value of the 'licence agreement' acquired (valued at R5280 000) in terms of either 11(a) or 11(gA) of the act.

On appeal to the tax court the question was whether the taxpayer had incurred expenditure as envisaged in 11(a) or 11(gA). The court in considering the ordinary dictionary meaning comes to the conclusion that a diminution of assets is required.⁷⁴ Goldblatt J, in relying on Silke, finds that the issuing of shares does not diminish the company's assets.⁷⁵

⁷¹ 17 SATC 208.

⁷² Income Tax act 31 of 1941.

⁷³ ITC 1783 supra note 4.

⁷⁴ Ibid para 7 2.

⁷⁵ Ibid.

The passage from *Silke* works with the concept of hypothetical settlement, namely what would be required of the company to hypothetically settle the obligation as it stands.⁷⁶

For example: An obligation incurred which clearly states a settlement price in cash, would hypothetically require a cash amount (diminution of assets) to settle. The approach of *Silke* states that regardless of the way in which it is actually settled this would be regarded as 'expenditure'. Where the agreement expressly states that settlement occurs by way of share issue/service rendering, there is no hypothetical possibility of a diminution of assets and as such no 'expenditure'. It should be noted that the authors gave no authority for their stated position.

The court consequently disallowed the deduction as the incurrance of an obligation to issue shares and the subsequent issuing thereof does not diminish the assets of the company.

3.2.3 ITC 1801⁷⁷

The taxpayer acquired the rights to a trademark, purchase price being valued at R44 462 000. The purchase agreement provided that consideration would be given by way of a share issue. The shares were consequently issued by the taxpayer, whereupon he claimed a deduction in terms of 11(gA). The commissioner disallowed it, claiming that the issue of shares by the taxpayer did not constitute expenditure actually incurred as compliance with its contractual obligation, did not require the taxpayer to expend any monies or assets.

The court holding in favour of the taxpayer, firstly referred to the principles laid down in *Edgars Stores*.⁷⁸ Namely that all that was required was the incurrance of an unconditional obligation. It was not necessary for it to be discharged in the year of assessment.

⁷⁶ A P de Koker & R C Williams 'Silke on South African Income Tax' (Subscription-based service only) [online] Available at <http://www.lexisnexis.co.za>. Accessed on 12 April 2013 para 7.4.

⁷⁷ ITC 1801 supra note 4.

⁷⁸ *Edgars Stores Ltd v CIR* 1988 (3) SA 876 (A).

But this was not in dispute, the real question being whether an obligation to issue shares could be regarded as ‘expenditure’. Namely could it be said that this was an obligation incurred which would lead to the hypothetical diminution of assets. Counsel for the commissioner relied on Goldblatt J in *ITC 1783* and his approval of Silke for support. Jooste AJ rejecting as follows:

‘The decision in case 10999 (*ITC 1783*) is in our view, with respect, clearly wrong and not a reflection of the law. Tax issues should not unnecessarily complicate or frustrate ordinary commercial transactions.’⁷⁹

Here the case becomes a bit more complicated. It is not completely clear whether Jooste AJ merely requires an incurrance of an obligation, regardless of the hypothetical settlement requirements, or whether he concedes that an obligation which requires the diminution of assets should be incurred, but that the issue of shares constitutes such a diminishment.

Burt is of the opinion that *ITC 1801* rejected the notion that ‘expenditure’ necessarily involves the diminution of assets.⁸⁰ He finds support for his contention in the courts reference to *Lace Proprietary Mines Ltd v CIR*.⁸¹ Jooste AJ finding on the basis of *Lace* that the issue of shares by an company in discharging purchase price, constitutes consideration given.

It is not clear how this necessarily implies that no diminishment is required. It merely regards the issue of shares as ‘consideration given’ which as will be discussed hereunder, does not necessarily equate to expenditure.

Burt’s argument does find some support in para 20 where the court addresses the passage from Silke:

“A perusal of the passage makes it clear no expenditure has been incurred where the quid pro quo consist of an issue of shares...has not lost or parted with any assets”... Mr Derksen, in my view correctly argued that this ignores the fact that the requirement is that the company should have *incurred an unconditional legal obligation and that, if it has done so, the deductibility requirement is met*...expenditure actually incurred is not dependent upon making payment... The contention also does not take

⁷⁹ *ITC 1801* supra note 4 para 24.

⁸⁰ K Burt ‘Issuing shares as consideration II – *ITC 1801* vs *ITC 1783*’ (2006) 20 *Tax Planning* 47 at 48.

⁸¹ 9 SATC 349.

cognisance of weighty English and South African authority...'⁸² (emphasis added)

The court also referred with approval to the following extract of Ger:

'...he (Goldblatt J) confused the concept of incurral of expenditure with the settlement thereof....the fact that it chose to settle this expenditure in shares should not change this reality.'⁸³

The alternative view on *ITC 1801* is found in De Swardt's article.⁸⁴ He contends that the case is not authority for the position as argued by Burt, but rather that the issue of shares for no consideration, constitutes a diminution of assets. He contends that support for this view is found in the following extract from the case:

'Where the obligation has been incurred, the *expenditure* becomes deductible if it also complies with the other requirements for deductibility laid down by the section...'⁸⁵ (His emphasis)

Further support is found in the courts approval of *Osborne*, in which the court held that where share-based payments are made, the issuer is giving up the right (*asset*) which it would otherwise have had to claim cash from the allottee and thus a diminution of assets occur.⁸⁶

The extract from Ger as approved by Jooste, also confirms this view: '...by issuing shares in lieu of paying in cash for the licence, it could be said that the taxpayer was indeed reducing its assets...'⁸⁷

As can be seen from the above, it is not clear what basis the court used for coming to its conclusion. It could even be said that the court approved of both the above mentioned contentions made by the authors. Despite this, *ITC 1801* however provides clear authority that shares issued as consideration constitutes expenditure actually incurred.

⁸² *ITC 1801* supra note 4 para 20.

⁸³ Ibid para 22, see B Gerr 'Income Tax: The problem of paying with shares' (2004) *De Rebus* 61 at 62.

⁸⁴ R de Swardt op cit note 15 at 482.

⁸⁵ *ITC 1801* supra note 4 para 7.

⁸⁶ Ibid paras 11 and 24.

⁸⁷ Gerr op cit note 83 at 62.

3.2.4 ITC 1822⁸⁸

The taxpayer in *casu* acquired a licence to access data from an international news service. Consideration would be provided in part by the issue of shares and part by the issue of debt by the purchaser. The purchaser consequently credited the seller on loan account and issued shares to extinguish the balance. Taxpayer claiming the full amount as a deduction in terms of s11(a). The court in considering the deduction relied on *ITC 1801*, stating: 'As to whether issue of shares constituted expenditure (i) That this question must be regarded as settled in the light of the comprehensive and most persuasive judgement of Jooste AJ in *ITC 1801*...' ⁸⁹

3.2.5 Commissioner for South African Revenue Service v Labat Africa Ltd⁹⁰

On appeal the North Gauteng High court confirmed the court a quo's finding in *ITC 1801*, specifically emphasising para 20 of that case as quoted above. This case seems to provide more support for the view as contended by Burt above, namely that a diminution of assets is not required. The court specifically states that even if the diminution test (dictionary meaning) would be accepted as correct, share-based payments would still be regarded as expenditure. This view is supported by applying a different construction to the transaction, in terms of which shares are first issued and paid whereupon the cash so received is used to pay the asset. The court contends that there exists no difference between such a construction and that which took place *in casu*.

⁸⁸ *ITC 1822* supra note 4.

⁸⁹ *Ibid* para 21.

⁹⁰ *Commissioner for South African Revenue Service v Labat Africa Ltd* supra note 4.

3.2.6 Commissioner for South African Revenue Service v Labat Africa Ltd⁹¹

Final word on the issue came in 2011 when a full bench of the appeal court found by word of Harms AP that share-based payments do not constitute expenditure.

The court considering *ITC 1801* stated that the wrong question was posed in determining whether expenditure was incurred. The tax court addressed the timing question in its reference to *Edgars Stores*, namely 'when was it incurred' rather than 'is it expenditure'. The court thus explicitly brings to an end any speculation on the question as to whether a diminution of assets is required, by stating that the mere incurrence of an obligation is not sufficient. Harms states:

'...the terms "obligation", "liability" and "expenditure" are not synonyms...the liability or obligation must be discharged by means of expenditure...'⁹²

The court finds support for this in the following statement by Botha JA in *Caltex Oil (SA) Ltd v SIR*:

'..."any expenditure actually incurred" meant all expenditure for which a liability has been incurred during the year, whether the liability has been discharged during the year or not...'⁹³

The researcher respectfully agrees with Marais, that this passage does not state that a liability should be discharged by means of expenditure, but rather that the liability and expenditure arise simultaneously.⁹⁴

It is consequently argued that the court placed the cart before the horse by requiring that a liability should be discharged by expenditure, as expenditure precedes a liability.⁹⁵ It is the expenditure that gives rise to a liability in the first place.

This problem arises as a result of the rather awkward wording applied in *Labat*. It is contended that one should rephrase Harms' requirement as follows to convey his true intention: 'The liability or obligation should

⁹¹ *Labat* supra note 8.

⁹² Ibid para 8.

⁹³ *Caltex Oil* supra note 31 at 12.

⁹⁴ A Marais 'The (In)Equity of *Labat*' 2013 *The Taxpayer* 4 at 7.

⁹⁵ TS Emslie & DM Davis Income Tax Cases and Materials 3 ed (2011) at 347.

require settlement by means of a diminution or movement of assets for the incurrence of the said liability to constitute expenditure actually incurred.⁹⁶

On this reading the liability and expenditure come into existence simultaneously on incurrence of an obligation which would hypothetically require a diminution/movement of assets. This is in accordance with the phrase form Silke as approved by Goldblatt J in *ITC 1783* and subsequently followed by Harms AP.

Burger agrees with this view in stating that a liability for something that is not an 'expense' cannot constitute expenditure.⁹⁷ Burt however disagrees. He feels that *Caltex* provides support for holding that the mere incurrence of an obligation in terms of which performance with a monetary value is due is sufficient. He states: 'The incurrence of an obligation as a fact cannot be affected by the means by which that obligation is discharged.'⁹⁸

What is clear from *Caltex* is that a link exists between the incurrence of the liability and expenditure. This is supported by the majority of authors as well as the dicta of Harms AP. As De Swardt correctly points out:

'What has to be determined is the extent and the specifics of the legal obligation on the company...and whether such a liability that has been actually incurred would constitute an 'expenditure.'⁹⁹

The appeal court continues in stating that the tax court posed to address the correct question in principle with reference to English case law and the question whether shares issued as consideration for assets could be regarded as consideration given. The problem however was that Harms AP did not regard English case law as case in point to the present enquiry as to the meaning of expenditure.

Given the acts absence of a definition for expenditure, the court availed itself to the dictionary meaning, applying a rather strict literal approach in its interpretation. The court in modifying the impoverishment test of *ITC*

⁹⁶ Cilliers op cit note 70 at 227.

⁹⁷ Burger *The Tax Tax Deductibility of Share-Based Payments made as Consideration for Services Rendered* (MCom (Tax) dissertation, UP, 2005) at 39.

⁹⁸ Burt op cit note 47 at 133.

⁹⁹ De Swardt op cit note 15 at 482.

1783, came to the conclusion that a movement of assets would be required at the very least.

As to the question whether the issue of shares constituted such a movement of assets, the court found in the negative, relying on *ITC 1783* among others.¹⁰⁰

¹⁰⁰ See *ITC 1783* supra note 4; *Commissioner for Inland Revenue v Estate Kohler* 1953 (2) SA 584 (A) and *Estate Furman v Commissioner for Inland Revenue* 1962 (3) SA 517 (A). All these cases confirm that a company's assets are not diminished by the allotment of shares.

3.3 English Case law

The tax court in *Labat* referred with approval to the English case law cited by counsel, stating that it was ‘*sound and represents a correct statement of law*’.¹⁰¹ This position was subsequently confirmed in the high court.¹⁰² Harms AP, on appeal however found that these cases had no bearing on the meaning of expenditure as used in s11(a), as it did not address ‘expenditure’ expressly but rather ‘consideration given’.¹⁰³

It is contended that English authority should be given further consideration in the light of approval by both aforementioned courts and learned authors.¹⁰⁴ Jansen van Rensburg however emphasises that it should be considered against the backdrop of a differing corporate tax base applied in the United Kingdom.¹⁰⁵ An English company is taxed on its ‘profits’.¹⁰⁶ As such they do not apply a general deduction formula as used in South Africa, but rather allow all costs relevant in profit calculation as a deduction, unless otherwise prohibited. Consequently the term ‘expenditure’ is not explicitly addressed in case law. Should this however be a deterrent to the application of the principles as enunciated in English case law, as contended by Harms AP?

What follows is an analysis of the four leading English cases on ‘expenditure’ as referred to in South African case law. The intention being to determine the applicability and contributory value of these cases to the question aforementioned, namely the meaning of ‘expenditure’ as used in the act.¹⁰⁷

¹⁰¹ *ITC 1801 supra note 4 para 24.*

¹⁰² *Commissioner for South African Revenue Service v Labat Africa Ltd* 72 SATC 75.

¹⁰³ *Labat supra note 8.*

¹⁰⁴ DM ‘Paying for goods or services by issuing shares’ (2004) *The Taxpayer* 86-87.

¹⁰⁵ Jansen van Rensburg *supra note 48* at 67.

¹⁰⁶ Section 35 of the Corporation Tax Act, 2009 (chapter 4).

¹⁰⁷ Section 11(a), 11(gA), 20(1)(a) of the Eight Schedule of the Income Tax Act 58 of 1962.

3.3.1 *Lowry v Consolidated African Selections Trust Ltd*¹⁰⁸

In casu the taxpayer issued shares to employees at par value. He claimed the difference between the market value and par as a deduction, arguing that the shares were issued at a discount in respect of services rendered.

In phrasing the question Viscount Caldecote L.C. states:

‘...I ask whether the issue of these shares in the manner adopted involved the respondent in any “distributions or expenses”...’

The majority dismissed the deduction stating:

‘respondents had neither transferred money or money’s worth to the members of the staff, and therefore the sum in question could not be treated as a disbursement or an expense which could be deducted in computing their profits.’

Viscount Caldecote L.C. states further:

‘Its capital was intact after the issue of the shares: not a penny was in fact disbursed or expended. Its trading receipts were not diminished, nor do I think it is a right view of the facts to say that the respondent gave away money’s worth to its own pecuniary detriment’¹⁰⁹

The minority held that the company had disbursed the difference as claimed.

Although this case addresses ‘expenditure’, it provides little guidance as to our problem, as it deals with the question whether a lost premium constitutes expenditure and not whether the issue of shares in itself is ‘expenditure’.¹¹⁰ Meyerowitz concurs with the majority in stating that the premium is a notional expenditure and not deductible, but states that on the facts the case is not precedent for holding that the issue of shares could not constitute expenditure.¹¹¹

¹⁰⁸ *Lowry v Consolidated African Selections Trust Ltd* 1940 2 All ER 545 (HL).

¹⁰⁹ *Ibid* at 657

¹¹⁰ Jansen van Rensburg *op cit* note 48 at 68.

¹¹¹ DM *op cit* note 104 at 87.

Jansen van Rensburg however contends the opposite, namely that the majority statement is wide enough to include the issue of shares at par.¹¹² The case was never considered by any of our courts and as such the true import remains uncertain.

3.3.2 *Osborne v Steel Barrel Co Ltd*¹¹³

In this case the taxpayer acquired trading stock for £10 000 cash and £30 000 fully paid up shares. The question before the court was what cost should have been allowed as a deduction for trading stock. The crown argued that as the shares cost the company nothing, the cost of the stock should be restricted to £10 000. Lord Greene MR rejecting this held:

‘The cases relied on in its support were *Inland Revenue Comrs v Blott* and *Lowry v Consolidated African Selection Trust Ltd*, neither of which, in our view, has any bearing on the point. The argument really rests on a misconception as to what happens when a company issues shares credited as fully paid for a consideration other than cash passing from the allottee. A company, therefore, when, in pursuance of such a transaction, it agrees to credit the shares as fully paid, is giving up what it would otherwise have had – namely, the right to call on the allottee for payment of the par value in cash. A company cannot issue £1,000 nominal worth of shares for stock of the market value of £500, since shares cannot be issued at a discount.... the consideration moving from the company must be at least equal in value to the par value of the shares, and must be based on an honest estimate by directors of the value of the assets acquired.”¹¹⁴

The court thus held that the ‘right forgone’ in issuing shares as fully paid up constitutes a cost to the taxpayer to the amount of the par value of the shares so issued.¹¹⁵ Costs incurred in the acquisition of trading stock is taken into account in calculating taxable ‘profits’ for purposes of the United

¹¹² Jansen van Rensburg op cit note 48 at 69; Bortz op cit note 49 at 12.

¹¹³ *Osborne v Steel Barrel Co Ltd* (1942) 1 All ER 634 (CA).

¹¹⁴ Ibid at 637-638.

¹¹⁵ This arguments merits are addressed in full in chapter 5.3 of this dissertation.

Kingdom Corporate tax act.¹¹⁶ As such 'cost' could provide a point of comparison for interpreting 'expenditure' in the act.¹¹⁷

Schoon argues that given a difference in historical context the 'right forgone' argument would no longer be suitable to South African tax law.¹¹⁸

The reason being that capital maintenance regime as applicable in *Osborne's* case is no longer applied in South Africa. Capital maintenance entails that a company cannot issue par value shares at less than par, subject to certain conditions.¹¹⁹ The new Companies Act removes the distinction between par and non-par value shares and requires in s40 that adequate consideration should be received for shares issued.¹²⁰ As such there is no obligation on the company to issue shares at par.

He contends that given the extinguishing of this obligation or 'right' to issue at par, the 'right forgone' argument as held in *Osborne* no longer has footing as the directors have no 'right' or obligation to demand par. He argues that it would lead to incongruity in that a party would be able to deduct the value of the shares, which might possibly have no relation to the value of the asset actually acquired.¹²¹

The researcher contends that more cognisance should have been taken of s40(3) as read with s76 and s77(2) of the new Companies Act. Section 76 emphasises director duties including the duty to avoid conflict of interest, to act in good faith, for a proper purpose and in the best interest of the company. It is suggested that a determination of 'inadequate consideration' can be challenged on the basis that one of these duties has been breached.¹²² As such it provides an indirect method of maintaining capital.

¹¹⁶ *Craddock v Zevo Finance Co Ltd* 1944 1 All ER 566 (CA) at 570.

¹¹⁷ Jansen van Rensburg op cit note 48 at 67.

¹¹⁸ AD Schoon *The tax effect of shares-for-future-services* (unpublished LLM theses, UP, 2011) at 42.

¹¹⁹ Section 81 of the Companies Act 61 of 1973 provided that par value shares could only be issued at a discount if a court resolution was obtained and a special resolution was passed.

¹²⁰ Section 35(2) of the Companies Act 71 of 2008.

¹²¹ Schoon op cit note 118 at 43.

¹²² Cassim et al op cit note 11 at 226.

Further it is not entirely clear how the removal of an obligation to issue at par value, removes the right to issue at par.¹²³ It is after all this 'right' that is being forgone by issuing shares as fully paid up.

This argument was however never considered in the *Labat* case as the share issue was concluded in 1999, thus the capital maintenance regime was still applicable in South Africa.

3.3.3 *Stanton v Drayton Commercial Investments Co Ltd*¹²⁴

In this case the taxpayer purchased an investment portfolio by issuing fully paid up shares at a premium. The question was whether this constituted 'consideration given' for purposes of capital gains tax in calculating the base cost of the asset. The court of appeal held that the 'consideration given' was the credit provided by crediting the shares as fully paid up and not the value of the shares themselves. The subsequent value of the consideration being the issue price agreed upon. The house of lords however found that the value of the shares themselves constitute 'consideration', but still valued with reference to the issue price agreed. Thus the 'consideration' differed, but not the quantum.

Jansen van Rensburg cautions against an unqualified application of *Stanton* to the 'expenditure' question as the court dealt with the phrase 'consideration given' which carries a wider import than 'expenditure' and states that such cases takes the enquiry no further.¹²⁵ Meyerowitz however still regarded it as additional authority to supplement *Osborne*.¹²⁶ If one accepts that 'cost' as considered in *Osborne's* case aids our cause, could it not be argued that reference by the high court in *Stanton* to the words of Lord Greene in *Osborne* illustrates that the court regarded 'consideration given' and 'cost' in the same light?¹²⁷ Nevertheless, the

¹²³ The question whether the right to issue shares for consideration constitutes a 'right' in the legal sense and as such an asset, will be discussed in chapter 5.3.3.

¹²⁴ *Stanton v Drayton Commercial Investments Co Ltd* 1982 1 All ER 121 (CA), *Stanton v Drayton Commercial Investments Co Ltd* 1982 2 All ER 942 (HL).

¹²⁵ Jansen van Rensburg op cit note 48 at 68, emphasises that the focus of 'cost'/'expenditure' is whether the taxpayer has expended something and not whether to counter-party has been recompensed, the latter being focused on in the case of 'consideration given'.

¹²⁶ DM op cit note 104 .

¹²⁷ *Stanton v Drayton Commercial Investments Co Ltd* 1980 3 All ER 221.

Inland Revenue conceded that the taxpayer incurred cost and the question was subsequently never addressed in court.

3.3.4 Craddock (Inspector of Taxes) v Zevo Finance Co Ltd¹²⁸

In casu the taxpayer acquired trading assets by issuing shares in the company at their nominal value. Revenue contended that the 'cost' of the assets acquired could not be equal to the nominal value of the shares issued. Lord Greene MR states the argument for revenue as follows:

'Mr Stamp's argument *rejects the whole basis of costs*, and asserts that the transaction was not ...one of sale and purchase, that there was *no such thing as cost*, that the investments *cost* the respondents nothing and that a *different basis to that of cost* must therefore be adopted.... the only basis which can be accepted is that of market value.'¹²⁹ (own emphasis)

Rejecting as follows:

'What then, was the substance of the transaction under which the respondent acquired these investments? First of all they acquired them by virtue of a contract of sale and purchase the validity of which, as importing legal rights and obligations between the parties to it cannot be impugned.... the respondents acquired the investments in consideration of their undertaking to the (seller) ... to issue fully paid shares... and it seems to me quite impossible to accept the view upon which Mr Stamp's whole argument was based that they must be taken as having acquired the investments in a manner which was not in law contractual and for no consideration at all.'¹³⁰

The House of Lords confirming through Lord Simonds says:

'I cannot distinguish between consideration and purchase price, and (using again the language of the Master of the Rolls) I find that, acquiring the investments "under a bona fide and unchallengeable contract", they paid the price which that contract required, a price which, whether too high or low according to the views of third parties, was the price upon which the parties agreed.'¹³¹

The court thus held that the 'consideration given' by the taxpayer was the agreed purchase price, being equal to the nominal value of the shares issued in *casu*.

¹²⁸ *Craddock* supra note 116.

¹²⁹ *Ibid* para 570E-H.

¹³⁰ *Ibid* para 571A-E.

¹³¹ *Craddock (Inspector of Taxes) v Zevo Finance Co Ltd* (1944) 27 TC 267 (HL) at 295.

It is contended by Jansen van Rensburg that *Craddock* does not take the enquiry any further as Inland Revenue conceded that 'cost' was incurred by the taxpayer.¹³² The researcher however finds this difficult to accept on a reading of the above quoted passages by Lord Greene MR in stating the argument for revenue.

3.3.5 Summary

Taken as a whole the above mentioned foreign cases, with the exception of *Lowry* illustrates a willingness to allow share-based payments as a deduction. With regards to what constitutes the exact consideration and what value to place thereon they however differ to some extent.

Despite all this, the court of appeal still felt that these cases do not add to the question of what constitutes 'expenditure' in terms of the act. As such this could be regarded as moot and irrelevant to our inquiry.

It is not disputed that 'consideration' and 'expenditure' on the ordinary dictionary meaning of the words are different and not substitutable terms.¹³³ What is emphasised is the context within which the word 'consideration' was considered in the above cases and the relevance ascribed to it therein. Although the *Craddock* case dealt with 'consideration given' it nevertheless considered whether this 'consideration' constituted 'cost' incurred in the acquisition of an asset for tax purposes.

The researcher believes that these cases, especially those that dealt with the issue of 'cost' add insight when discussing 'expenditure' and support the finding that share-based payments should be regarded as such.

¹³² Jansen van Rensburg op cit note 48 at 67.

¹³³ See A De Cock *Die uitreik van aandele ten einde verpligtinge na te kom – onkoste werklik aangegaan vir inkomstebelastingdoeleindes of nie* (unpublished MCom Tax theses, Stell, 2012) at 39-40 where the author clearly illustrates the difference in meaning between the two concepts.

3.4 Secondary sources on the meaning of expenditure

Van Zyl, in considering the definition of 'expenditure', also looks at 'consideration' as defined.¹³⁴ Consideration constitutes anything given or promised by one party in exchange for the promise or undertaking by another.¹³⁵ He contends that while 'expenditure' is restricted to the outlay of money, consideration has a wider meaning to include the exchange of anything for something else.

He refers with confirmation to Harms AP, where he states that expenditure can be in a form other than money. He continues in stating that as such the interpretation given to 'consideration' in Osborne's case fits in well in determining the meaning of 'expenditure'.¹³⁶

He confirms the diminution test laid down by Goldblatt J and Harms AP, but warns against a strict application of the impoverishment test as requiring a movement of assets. This could lead to confusing 'expenditure' with the actual payment or parting of assets.

He illustrates by way of the following example: 'By incurring a debt to obtain goods or services, the taxpayer's estate... will also lose value when it becomes indebted to pay an amount and hence be impoverished.'¹³⁷

The author is thus of the opinion that a diminution/impoverishment test is appropriate in determining expenditure, but that the movement of assets as required by *Labat*, is not correct.

Meyerowitz contends that 'expenditure' may take any form that has value in money or money's worth.¹³⁸ Where it does not take the form of cash, the expenditure equals the value of the asset transferred.¹³⁹ This is similar to the test applied by Watermeyer CJ in defining 'amount' in the context of gross income.

¹³⁴ S P Van Zyl 'The Meaning of "Expenditure" for Purposes of Section 11(a) and (gA) of the Income Tax Act 58 of 1962' (2012) *Obiter* 186 at 189.

¹³⁵ Oxford dictionary op cit note 59.

¹³⁶ Osborne supra note 113.

¹³⁷ Van Zyl op cit note 134 at 189.

¹³⁸ Meyerowitz 'Meyerowitz on Income Tax 2005-2006' (2006) *The Taxpayer* para 11 32.

¹³⁹ Ibid.

‘...the word ‘amount must be given a wider meaning, and must include not only money, but the value of every form of property earned by the taxpayer, whether corporeal or incorporeal which has a money value’,¹⁴⁰

‘Property’ being defined by Watermeyer CJ as follows: ‘... all rights vested in him which have a pecuniary or economic value.’¹⁴¹

As regards to what constitutes a ‘Money value’, there has been some differing opinions in our courts. *Stander’s* case held that an amount would only be included in a taxpayer’s gross income, if the amount could be turned into money or money’s worth by the taxpayer. This was thus a subjective enquiry into the taxpayer’s ability to turn the property received into money.¹⁴² *Brummeria* merely required that a monetary value should be able to be placed on the property, objectively speaking.¹⁴³

If the interpretation given to ‘amount’ above is applied to ‘expenditure’ mutatis mutandis, could it not be argued that the incurrence of an obligation (namely an obligation vested in taxpayer, which the extinguishing of, would require money’s worth) would in itself constitute expenditure.

Applying this to the facts of *Labat* one could possibly argue that the *Stander* approach would require that the extinguishing of the liability requires consideration by the taxpayer that is money, or could be turned into money by him. The researcher contends that this is the case, if one considers that the company could have issued the shares for cash.

On the objective approach of *Brummeria* it could be contended that regardless of the consideration given by the taxpayer, objectively speaking the party would still be regarded as having been indebted to the creditor for a monetary value being the purchase price debt.

As such, Meyerowitz’s approach would provide a satisfying symmetry between the concepts of ‘amount’ as used in gross income and ‘expenditure’ as used in the general deduction formula. Harms AP,

¹⁴⁰ *Lategan v CIR* 1926 CPD 203 at 208-9.

¹⁴¹ *CIR v Estate Crewe and Another* 1943 AD 656 at 667.

¹⁴² *Stander v CIR* 1997 (3) SA 617 (C).

¹⁴³ *CSARS v Brummeria Renaissance (Pty) Ltd* 2007 (6) SA 601 (SCA).

however regarded this as inappropriate, stating: 'The equation (if there is one) is therefore much more complicated than suggested by counsel.'¹⁴⁴ It is duly conceded that symmetry between income and expenditure is not a requisite of our tax system, but such a state of affairs still provides an amount of satisfaction.

De Swardt considers the key requirement of expenditure an outgoing diminishment or deprivation of the taxpayer's patrimony, or that something should have come from his pocket. This deprivation should be in money or something that has a value in money.¹⁴⁵ This would seem to correspond with Meyerowitz's view as stated above.

Silke submits that expenditure is not restricted to money, but that outflows in forms other than cash should also be included.¹⁴⁶ The following example is used as illustration: Where the taxpayer purchases goods in terms of a contract, and the purchase price is specified as a monetary amount, but the contract provides that settlement must or can take place by way of consideration in kind, that consideration would be regarded as 'expenditure actually incurred'. Where the purchase price is not specified as a monetary amount, the consideration in kind would not be regarded as expenditure. Reason being that no outlay or diminution of assets has been incurred.¹⁴⁷

What Silke thus requires is that the initial contract in terms of which the obligation is incurred, states a monetary amount. Namely the incurrence of an obligation which the hypothetical settlement of, would lead to the diminution of assets. The subsequent payment in this case (either in cash/shares/services or kind) is merely the discharging of the monetary

¹⁴⁴ *Labat* supra note 8 at para 17.

¹⁴⁵ De Swardt op cit note 15 at 479.

¹⁴⁶ Silke op cit note 76.

¹⁴⁷ Ibid.

obligation and thus not relevant. Cilliers contends that this is similar to the approach in *Labat*.¹⁴⁸

Where the initial contract states no monetary amount, but merely provides for consideration in kind in the form of shares/services rendered, there would be no expenditure. Reason being that the hypothetical settlement of the obligation does not require a diminution of assets.

Marais confirms that the word expenditure should be interpreted with reference to its ordinary meaning and the context within which it is used.¹⁴⁹ Despite this he feels that the courts approach in *Labat*, was 'overly conservative'. He contends that the meaning as attributed by the appeal court is so narrow that it could possibly even be a deterrent to expenditure incurred on loan account.

He is of the opinion that 'expenditure' has developed not as an ordinary dictionary meaning, but rather as a technical accounting term and that this technical meaning should be followed in tax law.¹⁵⁰

International Financial Reporting Standards (hereafter IFRS) defines expenses as follows:

'The definition of expenses encompasses losses as well as those expenses that arise in the course of ordinary activities of the entity.... They usually take the form of an *outflow or depletion of assets* such as cash and cash equivalents, inventory, property, plant and equipment' (emphasis added)¹⁵¹

This seems to confirm the approach that a diminution of assets is required, but it further provides:

'Expenses are recognised in the income statement when a decrease in future economic benefits related to a decrease in an asset or an increase of a liability has arisen that can be measured reliably. This means, in effect, that *recognition of expenses occurs simultaneously*

¹⁴⁸ See Cilliers op cit note 70.

¹⁴⁹ Marais op cit note 94 at 8.

¹⁵⁰ Ibid.

¹⁵¹ Para 4.33 of the *Conceptual Framework for Financial Reporting 2010*, issued by the International Accounting Standards Board and Approved by the Accounting Practices board (hereafter framework).

*with the recognition of an increase in liabilities or a decrease in assets...*¹⁵²

*'A liability is recognised ...when it is probable that an outflow of resources embodying economic benefits will result from the settlement...and the amount...measured reliably.'*¹⁵³

*'The settlement of a present obligation usually involves the entity giving up resources embodying economic benefits...for example by: (a) payment of cash; (b) transfer of other assets (c) provision of services... (e) conversion of the obligation to equity.'*¹⁵⁴

It would seem that IFRS applies a diminution test, but importantly does not restrict it to the outlay of assets. It also regards the incurrance of an obligation, of which the settlement would lead to an outflow of economic benefits as an expense. The two recognitions (expense and liability) occur simultaneously. This approach reminds us of the test applied by *Silke*, but instead of the hypothetical settlement requiring a diminution of assets, IFRS merely requires an outflow of economic benefits.

The issue of shares or rendering of services as consideration would be regarded as expenditure for accounting purposes, as this is regarded as an outflow of economic benefits.

Our courts have showed a general hesitance and unwillingness in the past as regards the application of accounting principles to tax law.¹⁵⁵ As *Partington* states '...if the person sought to be taxed comes within the letter of the law, he must be taxed...' ¹⁵⁶

Nonetheless in the *Golden Dump's* case the court in considering whether pending litigation could be regarded as a suspending the 'actual incurrance of expenditure', availed itself to 'contingency' as defined in financial accounting for assistance.¹⁵⁷

It is contended that accounting principles should not suddenly be accepted as stating the law, but that in the specific context of tax law, where the fields of accounting and law are often delicately intertwined, it would be unwise not to take consideration of the position as stated in accounting when interpreting the relevant provision in law.

¹⁵² Framework op cit note 151 para 4.49.

¹⁵³ Framework op cit note 151 para 4.46.

¹⁵⁴ Framework op cit note 151 para 4.17.

¹⁵⁵ See *Pyott Ltd v Commissioner for Inland Revenue* 13 SATC 121 at 126; *Caltex Oil* supra note 31 at 14.

¹⁵⁶ *Partington v Attorney General* 21 LT 370 para 375. Confirmed in *CIR v George Forest Timber* 1924 AD 516 at 531-2; *CIR v Estate Kohler* 1953 (2) SA 584 (A) at 592.

¹⁵⁷ *CIR v Golden Dumps (Pty) Ltd* 1993 (4) SA 110 (A) at 206.

3.5 Contributory value of loss?

As stated above, s11(a) of the act speaks of 'expenditure and losses actually incurred'. This leads us to ask what role if any this term 'loss' adds to our enquiry.

In *Joffe & Co (Pty) Ltd v Commissioner for Inland Revenue*, the leading case on the difference between loss and expenditure, Watermeyer stated: '...in relation to trading operations the word is sometimes used to signify a deprivation suffered by the loser, usually an involuntary deprivation, whereas expenditure usually means a voluntary payment of money.'¹⁵⁸

Meyerowitz is of the opinion that it would be problematic to assign a different meaning to expenditure from that given to losses.¹⁵⁹ It would seem then that the main difference is found in the involuntary nature of losses as opposed to the voluntary nature of expenditure.

This is in line with *IFRS* which states: 'Losses represent decreases in economic benefits and as such they are no different in nature from other expenses.'¹⁶⁰

Interestingly, the *Plate Glass and Shatterprufe Industries Finance Co (Pty) Ltd* case, dealt with the question whether an 'accounting loss', being the calculated exchange difference as between purchase date and year end, should be regarded as a loss for purposes of s11(a).¹⁶¹ The court finding in the taxpayers favour. Silke argues that in the absence of an interpretation of the word 'loss' by our courts, such a finding could not be supported as accounting principles are irrelevant for purposes of the income tax act.¹⁶² Nonetheless the court once again accepted accounting principles as informing the enquiry.

¹⁵⁸ *Joffe & Co (Pty) Ltd v Commissioner for Inland Revenue* 1946 AD 157 para 166.

¹⁵⁹ Meyerowitz op cit note 138 para 11 31.

¹⁶⁰ Framework op cit note 151 para 4.34.

¹⁶¹ 1979 (3) SA 1124 (T) at 108.

¹⁶² Silke op cit note 76 para 7.4.

3.6 Conclusion

The *Labat* case brings a binding end to any dispute as regards the import of 'expenditure' in the phrase 'expenditure actually incurred'. The researcher contends that Harms AP correctly required that the obligation should also satisfy the requirements of 'expenditure', as it is firmly established in statutory construction that every word in the act must be given meaning to.¹⁶³

The court consequently in providing the first binding definition of expenditure for tax purposes required a movement of assets. This reading would exclude shares issued for services rendered, or services rendered as consideration. This requirement is a bit more contentious and rightly so in the opinion of the researcher.

¹⁶³ L C Steyn *Uitleg van Wette* 5 ed (1981) at 17-19; *Golden Dumps* supra note 157 para 116.

Chapter 4 Actually incurred

4.1 Introduction

As already discussed, s11(a) and para20(1) of the eight schedule requires that 'expenditure be actually incurred'. Traditionally the whole phrase was considered as a whole and interpreted accordingly, but as our study has shown this approach has been changed in recent times and two distinct requirements have emerged. Up to now we have only addressed the first element, namely 'expenditure'. The question now turns to what 'actually incurred' means against the backdrop of *Labat*.

What follows is an brief discussion of the leading cases on the meaning of 'actually incurred', where after we consider the effect, if any, that *Labat* has had on this requirement.

4.2 Case law dealing with 'actually incurred'

4.2.1 Port Elizabeth Electric Tramway Co Ltd v CIR¹⁶⁴

In dealing with the phrase 'actually incurred', Watermeyer AJP (as he was then), states that use of the word 'actually' widens the field of application beyond the scope of necessity. He continues by saying that what is required is not actual payment, but the mere incurrence of an obligation to pay.

4.2.2 Concentra (Pty) Ltd v CIR¹⁶⁵

In casu the taxpayer company, agreed to compensate directors for travelling cost incurred on company business. The liability was incurred over a period of three years, upon completion of which the company paid the directors and claimed the total expenditure. The court rejecting, states that expenditure had to be deducted in the year in which the liability arose, regardless of when actual payment occurred.

¹⁶⁴ 1936 CPD 241, 8 SATC 13.

¹⁶⁵ 1942 CPD 509, 12 SATC 95.

4.2.3 Caltex Oil (SA) Ltd v SIR¹⁶⁶

The taxpayer incurred two debts in sterling pounds. These debts subsequently declined as a result of favourable exchange rates. The effect being that one debt was settled at a lesser amount (in rand value) than the amount initially incurred. The other being carried at a lesser amount on year end than initially recognised. The question arose what amount (in rand) should be regarded as actually incurred?

The court found that it is only on year end that expenditure actually incurred can be determined. The rand value of the unsettled debt on year end would consequently be deductible. As regards the debt settled before year end, it is the amount paid that would be deductible.

This case has been the topic of much discussion as a result of Harms AP's reliance thereon for stating that: 'the liability or obligation must be discharged by means of expenditure.'¹⁶⁷

4.2.4 Nasionale Pers Bpk v KBI¹⁶⁸

The taxpayer company paid bonuses to its employees on 30 September each year, on condition that the employee was still in the employ of the company as at 31 October. The company claiming these bonuses as a deduction for the year ending 31 March of the same year.

The taxpayer argued that the condition was of a resolutive nature and as such not an impediment to the incurrence of an unconditional obligation. The court finding that regardless of the nature of the uncertainty (whether resolutive or suspensive), where an uncertainty as to the obligation existed after year end, it could not be said that an unconditional obligation has been incurred.

The court also found although obiter, that where an obligation is paid before the unconditional obligation comes into existence, the expenditure would still be regarded as actually incurred only on incurrence of the

¹⁶⁶ *Caltex Oil* supra note 31.

¹⁶⁷ See chapter 3.2.6 for full discussion.

¹⁶⁸ *Nasionale Pers* supra note 31.

obligation. Advance payment of an expense, before liability to pay has arisen does render the outlay of cash/assets, expenditure actually incurred.¹⁶⁹

4.2.5 Edgars Stores Ltd v CIR¹⁷⁰

Edgars was party to a lease agreement. The lease provided that basic rent be payable on a monthly basis, but should turnover exceed a yearly limit, an additional amount would be payable. The taxpayer's year end being before the completion of lease year, the question arose whether the turnover rental, based on turnover levels only determinable at end of lease year, was deductible.

The court being in agreement as to the law, the case hinged on a question of fact. Did the rental clause create an unconditional obligation in tax year which was only quantifiable at end of lease year, or did it postpone the incurrence of an unconditional obligation to end of lease.

The full bench agreed that where the amount could only be quantified at a later stage falling outside of tax year, the deduction would still be allowed, provided that an unconditional obligation exists at year end.¹⁷¹

The majority by word of Corbett JA, held that there existed two distinct rental obligations, namely basic and turnover. The judge finding that as regards the turnover rental, the obligation only becomes unconditional at end of lease year. This falling outside the tax year, no unconditional obligation existed and deduction was disallowed. Nicholas AJA dissenting on the question of fact as stated above.

¹⁶⁹ Income Tax Cases and Materials op cit note 95 at 327, reference is also made to *ITC 380 9 SATC 347* at 348, where the court found that moneys paid out constitute expenditure actually incurred at date of payment.

¹⁷⁰ *Edgars* supra note 78.

¹⁷¹ See the court a quo, *CIR v Edgars Stores Ltd* 1986 (4) SA 312 para 319, where Ackermann J discusses the courts approach to unquantifiable amounts. He states that courts are willing to work with a deduction in case of uncertainty, which is fair and reasonable. The taxpayer has merely to establish the amount on a balance of probability.

4.2.6 CIR v Golden Dumps¹⁷²

The taxpayer company employed a financial director (Nash) on agreement that he be entitled to certain shares at R88 250 on completion of certain negotiations. Nash was subsequently discharged upon which he claimed transfer of the shares on 6 January 1981. The company refused and court proceedings ensued. The court finding in favour of Nash on 27 March 1985. The company in complying with the order, incurred a loss which it sought to deduct in the 1985 year of assessment.

The court found that there exists no difference in principle between a contingency in the legal sense and one in the popular sense. As to what constitutes a contingency in the popular sense the court states: 'a claim which was disputed, at any rate genuinely disputed and not vexatiously or frivolously for the purposes of delay...'

The court comes to the conclusion that where the outcome of a dispute as regards the expenditure is undetermined at year end, it cannot be said to be actually incurred. The court allowing the deduction in the 1985 year of assessment.

4.2.7 ITC 1444¹⁷³

Contracts were concluded by the taxpayer for the acquisition of certain production materials. The contracts provided for a fixed or determinable price and it was agreed that the contracts created an unconditional obligation on the part of the taxpayer to purchase the materials. The taxpayer claimed these deductions in the year the contracts were concluded, but before delivery of the materials. The commissioner not allowing the deduction.

The court by word of McCreath J holding that the taxpayer's liability to pay was conditional upon the seller's performance, namely his delivery of the bills of lading. Prior to this delivery the taxpayer has not 'actually incurred'

¹⁷² 1993 (4) SA 110 (A).

¹⁷³ 51 SATC 35.

an unconditional obligation to pay. Consequently no deduction was allowed.

What ITC 1444 then requires is not just the absence of any suspensive or resolutive condition in the legal sense, but also an indefeasible duty to pay before end of tax year.¹⁷⁴ This however does not mean that it should be payable in the year of assessment. Should the taxpayer pay before year end, but the indefeasible duty to pay has not arisen, it would seem that the expenditure would still be regarded as not 'actually incurred' on the reading of *Nasionale Pers v KBI*.¹⁷⁵

4.2.8 *Ackermans Limited v CSARS*¹⁷⁶

The taxpayer company sold a business to pep stores at a purchase price of R800 million. The taxpayer contended that the asset value of the business sold was equal to R1 129 million. It accepted the amount of R800 million in conjunction with pep taking over its contingent liabilities to the amount of R329 million. *Ackermans* subsequently claimed the portion of the asset purchase price it had foregone, being equal to the value of the contingent liabilities as expenditure in terms of s11(a). The commissioner contending among other that the foregoing did not constitute 'expenditure' or 'expenditure actually incurred'.

The court unfortunately did not deal expressly with the issue whether the right foregone constitutes 'expenditure', but rather focused on the second element namely whether it was actually incurred.

The court stating:

"expenditure incurred" means the undertaking of an obligation to pay or (which amounts to the same thing) the actual incurring of a liability. No liability was incurred by *Ackermans* towards Pepkor in terms of the sale agreement.¹⁷⁷

The foregoing of the full purchase price, was not regarded in fact or law as 'expenditure incurred'. The taxpayer never had an obligation towards

¹⁷⁴ *Income Tax Cases and Materials* op cit note 95 at 338.

¹⁷⁵ *Nasionale Pers* supra note 31 at 73.

¹⁷⁶ 2011 (1) SA 1 (SCA).

¹⁷⁷ *Ibid* para 8.

Pepkor, which could be said to have been discharged by the accepting of a lesser purchase price. Consequently no expenditure was actually incurred.

4.3 Summary and the effect of *Labat* on ‘actually incurred’.

Having regard to all of the above stated cases, the researcher contends that the position as to what ‘actually incurred’ means can be summarised as follows.

It requires the incurrence of an unconditional obligation, both in the legal and popular sense. This entails that there should be no unsettled disputes as regards the obligation. Further this obligation should be of such a nature that the taxpayer has an indefeasible duty to pay. This does not require that it should be paid or payable in the year of assessment. Finally the obligation would still be regarded as ‘actually incurred’ if it only becomes quantifiable after year end, as long as an unconditional obligation exists. Finally we need to consider the effect of *Labat* on the above stated position.

As discussed above, *Labat*, required that the unconditional obligation be discharged by means of expenditure. This was criticised by many as placing the cart before the horse. The researcher contended on the reading of Cilliers, that the wording should be rephrased to give effect to the true intention of Harms AP.

‘The liability or obligation should be discharged by means of a diminution or movement of assets for the incurrence of the liability to constitute expenditure actually incurred.’ (Rephrased)¹⁷⁸

On this reading, *Labat*, has not affected the ‘actually incurred’ requirement. The test will still be whether an unconditional obligation has been incurred as discussed in case law above. *Labat*, rather amends the existing position by circumscribing the nature of the obligation incurred. The obligation while still complying with all the above stated requirements

¹⁷⁸ Cilliers op cit note 70.

should now be of such a nature that its hypothetical discharge would require the diminution or movement of assets. In such a case the obligation would constitute 'expenditure'.

Chapter 5 Commentary on *Labat* and the true meaning of ‘expenditure actually incurred’.

5.1 Introduction

As the discussion above has already shown, the *Labat* case and its implications for share-based payments and the rendering of services as consideration has been met with a large deal of criticism and academic debate. In consequence, a variety of arguments exist that pose to either refute or support the reasoning of Harms AP.

What follows in this chapter is an attempt by the researcher to summarise all these arguments in to a more defined list. Each argument will be analysed individually by looking at both academic and judicial viewpoints on the issue. Thereafter the researcher will pose to conclude each item by providing an opinion as to the merits of the argument.

5.2 “The Cart before the Horse” argument

5.2.1 The argument

Marais accepts that the terms ‘expenditure’ and ‘obligation’ are not synonyms, but argues that an obligation always arises from expenditure.¹⁷⁹ An obligation cannot exist without expenditure being incurred in the first place. Thus he contends that the court conceptually erred in regarding an obligation as preceding the expenditure when it stated that the obligation should be discharged by way of expenditure.¹⁸⁰ He finds support for his statement in the basic principles of accounting.

In accounting assets equal the sum of liabilities and equity. Thus where a liability (obligation) increases (credit entry), this has to be represented as either a decrease in equity (expenditure) or an increase in assets (debit entry). The expenditure and obligation thus come into existence simultaneously. It is on this basis that Marais argues that the existence of an unconditional obligation, such as the obligation to issue shares, is a smoking gun as to the existence of expenditure.

He contends that in determining whether expenditure exists, one has to look at the reason why the obligation arose in the first place, and not with reference to how the obligation would be settled in future.

Emslie supports this argument in stating expenditure must first exist before it can be actually incurred.¹⁸¹ Expenditure does not discharge a liability, but rather gives rise to it in the first place. It is payment or performance that discharges the obligation that flows from the notionally anterior expenditure. All that is required for expenditure to be actually incurred is

¹⁷⁹ Marais op cit note 94 at 4.

¹⁸⁰ *Labat* supra note 8 para 8.

¹⁸¹ Editorial ‘Income Tax – Deductions – Expenditure Actually Incurred – Meaning of Expenditure – Shares Issued as Consideration not Expenditure: CSARS v Labat Africa Ltd’ (2011) *The Taxpayer* 167.

the existence of an unconditional obligation; the manner of subsequent discharging is irrelevant to this enquiry.¹⁸²

The author none the less affirms the point as raised by Harms AP that one has to have expenditure before the question of 'actually incurred' even arises. As to what this expenditure should entail, it would seem from the above, that the mere incurrence of an obligation would suffice.

Cilliers agrees that expenditure must exist before the question of actually incurred becomes of concern, but importantly adds that one needs to ask in what sense expenditure must exist.¹⁸³

In rejecting the 'cart before horse' argument of the above mentioned authors, Cilliers contends that one can approach 'expenditure actually incurred', in such a way as to harmonise the concerns of Marais and Emslie with that of Harms AP in *Labat*.¹⁸⁴

He argues that 'expenditure actually incurred' although providing two distinct requirements, should nevertheless be read as a whole with the words giving colour and context to each other.¹⁸⁵

- (i): 'expenditure' requires a diminution or movement of assets.
- (ii): 'actually incurred' requires the incurrence of an unconditional obligation.

The two requirements interact in such a way as to raise and lower the bar for compliance. 'Expenditure' raises the bar in requiring more than the mere incurrence of an unconditional obligation as required by (ii), by qualifying the subject matter of the obligation. The obligation should be of such a nature that its discharge would require the diminution/movement of

¹⁸² Editorial 'Income Tax – Expenditure Actually Incurred – Payment By The Issue Of Own Shares: CSARS v Labat Africa Ltd 72 SATC 75' (2010) The Taxpayer 38. This also supported by Ger op cit note 83.

¹⁸³ Cilliers op cit note 70 at 226.

¹⁸⁴ Ibid.

¹⁸⁵ This approach finds support in the *CSARS v Airworld* CC 2008 (3) SA 335 (SCA) where the court held that a word must '...take its colour, like a chameleon from its setting and surrounds in the act.'

assets. On the other hand actually incurred, lowers the bar for (i), by requiring a mere obligation, and not actual settlement.

On this reading of para 8 of *Labat*, the obligation is not regarded as preceding the expenditure, but rather that they come into existence simultaneously, given that the obligation's subject matter conforms to the above mentioned requirements.

As Cilliers states:

‘It seems that Harms AP did not really put the cart before the horse. He simply looked at the cart first, ignoring the horse altogether, because the answer to the question with which the court was confronted was to be found in the cart.’¹⁸⁶

The big difference between Cilliers approach on the one hand and Marais and Emslie on the other, is that he looks at the method of discharge/payment in order to ascertain the existence of expenditure, whereas the other two authors argue that this is irrelevant in ascertaining expenditure and that the answer should rather lie in the reason for the incurrance of the obligation in the first place.

Jansen van Rensburg takes a view similar to that of Cilliers as regards the *Labat* case.¹⁸⁷ The author emphasises that the mere incurrance of an unconditional obligation is not sufficient, but that regard has to be taken of the nature or subject matter of the obligation. The obligation should be of such a nature that its discharge would require a movement of assets. Thus focus is once again placed on the method of payment, in ascertaining whether expenditure exists.

Van Zyl agrees with *Labat* that ‘expenditure’ adds a distinct requirement to the question of ‘expenditure actually incurred’.¹⁸⁸ The problem lies in the application and content as to what constitutes ‘expenditure’.

He argues that the court failed to distinguish between expenditure and the consequent discharge thereof in stating in par 6 that an obligation should

¹⁸⁶ Cilliers op cit note 70 at 228.

¹⁸⁷ Jansen van Rensburg op cit note 48 at 63.

¹⁸⁸ Van Zyl op cit note 134 at 188.

be discharged by way of expenditure.¹⁸⁹ He contends that *Labat* confused the meaning of expenditure in holding that it required actual payment.¹⁹⁰ This is contrary to the well-established rules concerning 'actually incurred' as laid out in *Naspers*, *Edgars Stores* and *Caltex* which hold that an unconditional obligation is required, not actual payment.¹⁹¹

It is argued that this creates a situation in which a person incurring a unconditional obligation in year one, but only paying in year two would never be able to deduct, as the expenditure only exists in year two, but it was actually incurred in year one and should have been deducted accordingly in that year.¹⁹²

The researcher contends that this viewpoint taken by the learned author is incorrect, and that *Labat* did not require actual payment before expenditure could be said to exist. In this regard the interpretation of *Labat* as given by Cilliers and Jansen van Rensburg is argued to be more correct.

As regards the meaning to be attributed to 'expenditure', the author having regard to the diminution requirement as laid down by Harms AP approves a so called impoverishment test.¹⁹³ It is however difficult and often awkward to apply as the party will often be only temporarily impoverished and not be poorer at the end of the day, as the assets acquired are more valuable than the purchase price given up. Given this difficulty, the author cautions against confusing the incurrence of expenditure with the subsequent payment or parting of assets.¹⁹⁴ This point is also emphasised by the 'cart before horse' supporters as mentioned above.

Harms AP in applying this impoverishment test added the requirement of asset movement as a minimum. Van Zyl argues that this is unfounded and that impoverishment would not necessarily coincide with the movement of

¹⁸⁹ Ibid.

¹⁹⁰ Ibid.

¹⁹¹ See chapter 4 on actually incurred.

¹⁹² Van Zyl op cit note 134 at 188.

¹⁹³ Ibid at 189.

¹⁹⁴ Ibid.

assets.¹⁹⁵ As an example he describes the typical situation of barter trading and the anomaly that would arise should *Labat* be followed.

A (dentist) and B (painter) decide to render services to each other in their respective trades to the value of R10 000. A renders a service to the value of R10 000 (he could have charged another patient this amount) in exchange for which he receives painting services from B to the value of R10 000. On the reading of *Labat*, A would not be able to deduct the R10 000 he expends on painting as there is no change in A's assets. He would nevertheless still be taxed on the amount he becomes entitled to as a result of the rendering of his dental services.¹⁹⁶

Van Zyl states that a person's estate becomes impoverished by the incurrance of a debt to pay the opposite party.¹⁹⁷ He continues in stating that A in the above scenario becomes impoverished through the foregoing of his right that he would otherwise have had to claim the R10 000 for his dental services.¹⁹⁸ Expenditure does not require actual payment.

As regards the issue of shares, Van Zyl nevertheless agrees with Harms AP, that it only impoverishes the shareholders and not the company itself. Consequently no expenditure would exist on the facts of *Labat* in Van Zyl's opinion.

Van Zyl's objections raise interesting questions as to the role played by impoverishment and the diminution or movement of assets in connection with our enquiry. Is the diminution/movement of assets essential or would something less suffice? Should the incurrance of an obligation which impoverishes be enough to constitute expenditure despite not affecting assets? These questions are discussed in the final part of this section.

¹⁹⁵ Ibid.

¹⁹⁶ Gross income as defined in section 1 para (c) of the act.

¹⁹⁷ Van Zyl op cit note 134 at 189.

¹⁹⁸ This will be addressed in chapter 5.3 where we discuss the right forgone argument.

5.2.2 Movement of assets?

As our discussion in chapter 3.2 above has shown cases before *Labat* held differing opinions as to this question. *ITC 1783* holding that an diminution was required whereas the North Gauteng High Court confirming *ITC 1801* found the contrary.

Burt argues that *ITC 1801* required an unconditional obligation in terms of which performance with a monetary value is due.¹⁹⁹ Relying on *Caltex Oil* he states that the consequent means of disposal is of no importance and that no movement of assets is required.²⁰⁰

Burger in response argues that *Caltex* clearly requires that expenditure must exist prior to the question of 'actually incurred' becoming relevant.²⁰¹ A liability that is not an expense cannot pass the test. He criticises Burt's position with reference to a barter trade.²⁰²

Take again our example of A and B as discussed above. A incurs an obligation to render dental services with a monetary value of R10 000 in exchange for the painting service of R10 000. Applying Burt, A would thus have incurred an obligation with a monetary value and be able to deduct R10 000. His net taxable income would thus be zero, as this is cancelled out by the R10 000 taxable income. Burger criticises this view on the basis that A would never be subject to tax. The researcher contends that this loses track of the fact that the taxpayer is still being taxed on all his income. Should there be a difference in values as regards the respective services; A would still have been taxed. The fact that his expenditure equals his income should not be a deterrent to allowing the expenditure in the first place.

De Swardt in considering both the above mentioned arguments, states that the enquiry should still be whether the unconditional obligation amounts to an expense, and not merely whether it carries a monetary

¹⁹⁹ Burt op cit note 47 at 133.

²⁰⁰ Ibid.

²⁰¹ Burger op cit note 97 at 39.

²⁰² Ibid at 41.

value.²⁰³ In determining whether the obligation amounts to expenditure, one would have regard to the extent/specifics of the obligation.²⁰⁴ Is it of such a nature, that an expense exists or would exist upon discharge of the liability. Expense in this context entails impoverishment which in turn requires a diminution of assets.

5.2.3 Concluding remarks

It is undeniable that the word expenditure added a dimension to the enquiry. The tests as laid down in *Nasionale Pers* and *Edgars Stores* never explicitly considered what expenditure adds to the question. Consequently Harms AP was completely correct to emphasise that expenditure was not synonymous with obligation/liability.

As the above collection of opinions and cases has shown, there is no clear answer as to the question whether the mere incurrance of an obligation is sufficient for expenditure to be actually incurred. Case law before *Labat* gave differing opinions. *ITC 1783*, *ITC 1801* (on the De Swardt reading) and the supreme court of appeal all held that a diminution/movement of assets would be required. *ITC 1801* (on Burt's reading) and the High Court in *Labat* required a mere obligation.

Those in favour of the mere obligation position, rely on the cases as addressed as part of 'actually incurred', which as shown above did not focus much attention on the element of 'expenditure' in isolation, but rather considered the whole phrase. The researcher contends that these cases might be of less assistance in this regard, as one is not sure if they are merely addressing the timing issue. For this reason the position of *Labat* is preferred. Expenditure has to be shown to exist.

Here we encounter another divide as 'mere obligation supporters' argue that expenditure should be defined on the basis of the reason for coming into existence of the obligation, whereas the 'asset movement supporters' argue definition on the basis of hypothetical settlement requirements.

²⁰³ De Swardt op cit note 15 at 482.

²⁰⁴ Ibid.

Should expenditure be made dependant on the future method of discharge or is this irrelevant to the enquiry?

As an interesting closure to this argument one may make mention of Marais' argument as regards asset diminution.²⁰⁵ The author, although not supporting an asset diminution requirement, nevertheless concludes that a diminution of assets exists on the facts of *Labat*.²⁰⁶ If one should for arguments sake accept that the shares were issued before *Labat* received the trademark, *Labat* would have a right to receive the trademark as consideration for the shares issued at date of issue (Case 1). This right to receive the trademark (a personal right to performance of a legal object) would constitute an asset for *Labat*. On subsequent receipt of the trademark, this right would cease to exist. Thus a diminution of assets can be said to have taken place.

This at first glance seems to provide a clear and simple answer to our enquiry, but one should remember that Marais was 'tweaking the facts' in regarding the shares as being issued first. This theory provides no answer in the case where the trademark was first received (as was the case in *Labat*) and a subsequent obligation to issue shares existed (Case 2). Upon issue, an obligation is discharged, but no asset is diminished. As Harms AP has stated: 'The fact that the parties may have constructed their agreement differently and tax-efficiently is entirely beside the point.'²⁰⁷

The researcher contends that this illustrates the arbitrary nature of the test as applied in *Labat*. How could the existence of expenditure, be made contingent on the sequence in which payment is made. It is contended that Marais' approach to determine expenditure on the basis of what gives rise to the obligation in the first place, is to be preferred over the approach of defining on method of settlement.²⁰⁸ The court also erred in not regarding the incurrance of an obligation in a similar light to the diminution of an asset as illustrated by the following.

²⁰⁵ Marais op cit note 94 at 7.

²⁰⁶ Ibid.

²⁰⁷ *Labat* supra note 8 para 15.

²⁰⁸ Marais op cit note 94 at 7.

In Marais' tweaked set of facts no obligation arose, but rather an asset diminishment occurred upon receipt of the trademark. In this case, his test as to what gives rise to the obligation in the first place should accordingly be adjusted as follows: 'What gave rise to the diminution of assets in the first place.'

The answer to both questions in case 1 and 2, would be the same, namely the acquisition of an trademark. It is on this basis that expenditure should accordingly be defined. Whether an obligation is incurred or an asset is diminished is merely indicative of the sequence of events. This approach would be in accordance with IFRS by regarding expenses as arising from either a decrease in assets or an increase in liabilities.²⁰⁹

²⁰⁹ Framework op cit note 151 para 4.49.

5.3 The 'Right forgone' argument

5.3.1 The argument

This argument assumes that a diminution of assets is a prerequisite for expenditure. It does not dispute the interpretation given to expenditure by Harms AP, but rather finds fault with the conclusion that shares issued as fully credited up does not involve a movement or diminution of assets.

Ger states that by issuing shares in lieu of a cash payment, a company is reducing its assets, by giving up what it would have been entitled to claim, namely payment in cash, for the issue of its shares.²¹⁰

Van Zyl as we have seen above in 3.2.1 argued for an impoverishment test that does not necessarily require a movement of assets. He nevertheless also supported the idea of impoverishment by way of a 'right forgone'.²¹¹ He states that a taxpayer, who has incurred expenditure without parting of any money/assets, but rather by parting with the right to charge money, should still be entitled to deduct his expenses.²¹² The company would be impoverished in the sense that it receives no payment where it could have received payment should he not have forgone the right. The value of the expenditure would then equal the value of the original obligation incurred, provided that it has a certain monetary value.

As regards case law, English authority for this argument is found in the *Osborne* case where Lord Greene MR states:

'The primary liability of an allottee of shares is to pay for them in cash, but when shares are allotted credited as fully paid, this primary liability is satisfied by a consideration other than cash passing from the allottee. A company, therefore when in pursuance of such a transaction, it agrees to credit the shares as fully paid, is giving up what it would otherwise have had – namely the right to call on the allottee for payment of the par value in cash.'²¹³

As we have already seen in our discussion on English authority in chapter 3.3, Harms AP, did not regard these foreign cases as providing any assistance into the enquiry. As a consequence this argument was never

²¹⁰ Ger op cit note 83 at 62.

²¹¹ Van Zyl op cit note 134 at 190.

²¹² Ibid.

²¹³ *Osborne* supra note 113 at 637-638.

considered by a South African court. It is nevertheless contended that this argument should be given further attention based on our previous discussion on the relevance of Osborne.²¹⁴

5.3.2 More than just a spes, a personal right?

De Swardt finds support for the right forgone argument in the companies act.²¹⁵ As we have already discussed in the general overview of shares and share-issues, shares can be issued for a cash or kind consideration. The shares can however only be issued once they are fully paid up. There is thus a quid pro quo required for every share issued.

This quid pro quo is regarded as a primary right of the company.²¹⁶

Namely the right to receive the subscription price in cash. Where the parties however agree to consideration in kind, this right will still exist but cash consideration will not be enforceable against the subscriber.²¹⁷

Where a company thus agrees to credit shares as fully paid up, it is giving up this right which it would otherwise have had to call on the allottee for payment in cash.

De Swardt continues in stating that the forfeiture of an expectation could be classified as the forfeiture of a spes.²¹⁸ A spes in turn is merely regarded as a hope/expectation of performance and thus not regarded as an enforceable right in law.²¹⁹ The author however regards the primary right that is given up on acceptance of consideration in kind, as something more than a mere spes.²²⁰

He argues that this primary right could be regarded as a personal right against the allottee for payment, which would have been enforceable if the subscription agreement did not provide for consideration in kind. Thus by agreeing to consideration in kind (crediting the shares as fully paid up), the

²¹⁴ See chapter 3.3.

²¹⁵ De Swardt op cit note 15 at 483.

²¹⁶ Blackman op cit note 20 at 255.

²¹⁷ Ibid.

²¹⁸ De Swardt op cit note 15 at 484.

²¹⁹ PM Nienaber 'Cession' 2 ed *LAWSA* vol 2(2) (2003) para 21.

²²⁰ De Swardt op cit note 15 at 484.

company is parting with a personal right which in turn diminishes its assets.²²¹

5.3.3 Is this right an asset?

In our introductory discussion as to the meaning of expenditure, we briefly looked at the meaning of ‘assets’.²²² We found that it entails a subjective right to patrimonial objects. Thus a claim to a legal object with economic or material value. These among others include personal rights to performance, such as requiring a person to do or render something.

We have seen further that before share issue, there exists no property (assets) for either the company or the shareholders.²²³ Upon issue, a asset comes into existence for the company in the form of a personal right to claim subscription consideration from the allottee. The allottee on the other hand receives the shares which constitute an asset in his hands.

Van Rensburg argues on the above mentioned, that prior to issue a company has no ‘personal right’ to issue shares for cash.²²⁴ The ‘right’ that *Osborne* was referring to was rather the capacity/power to issue shares to raise capital, and not a personal right in the legal sense to receive cash consideration.²²⁵ The author consequently finds that this ‘right’ to issue shares for consideration cannot be regarded as an asset in the legal sense.

5.3.4 Is an asset in the legal sense required?

This question arises from the statement by Ger, that not only cash outlays as implied by *ITC 1783*, but all economic sacrifices associated with the acquisition of an item should be regarded as expenditure.²²⁶ He thus works with the concept of notional expenditure. The diminishing of assets should refer to economic sacrifices in the broader sense.

²²¹ Ibid.

²²² See chapter 3.1.

²²³ See chapter 1.3.

²²⁴ Jansen van Rensburg op cit note 48 at 71.

²²⁵ Ibid.

²²⁶ Ger op cit note 83 at 62.

Van Rensburg in addressing this question refers to two cases in which the enquiry into strict adherence to the legal meaning came to the fore.²²⁷ The first being *Brummeria Renaissance*.²²⁸ *In casu* the court considered whether a right to interest free loans, constituted an 'amount' for purposes of gross income as defined in s1.

"Amount" was defined by Watermeyer J in *Lategan v CIR* as being not only money, but the value of any property earned by the taxpayer which has a monetary value.²²⁹

Jansen van Rensburg states that supreme court of appeal found that the interest free loan constituted an amount despite the fact that it would not be regarded as property in the legal sense.²³⁰ The researcher differs from this conclusion. Could it not rather be said that a different interpretation was given to 'property' by the court to that as defined in *Stander*.²³¹

Namely that property would not require an amount to be capable of being turned into money by the receiver as required by *Stander*. Thus on this interpretation, the court still regarded the interest free loan as property in the legal sense when it found it to constitute an amount. There was no detracting from the legal meaning but rather a different interpretation of the legal meaning.

The second case which Jansen van Rensburg refers to is that of *Ackermans*.²³² As already discussed in 4.2.8, the case deals with the question whether the foregoing by the seller of the full purchase price in exchange for the acceptance of contingent liabilities by the purchaser could be regarded as expenditure actually incurred.

Counsel for the taxpayer argued that expenditure includes all 'actual, quantifiable diminutions or prejudicial effects suffered by the taxpayer's patrimony'. He continued in stating that it was not limited to the incurrence of legal obligations, but rather embodied a commercial or economic

²²⁷ Jansen Van Rensburg op cit note 48 at 71.

²²⁸ *Brummeria Renaissance* supra note 143.

²²⁹ *Lategan v CIR* 1926 CPD 203 at 208-9.

²³⁰ Jansen van Rensburg op cit note 48 at 72.

²³¹ *Stander* supra note 142.

²³² *Ackermans* supra note 145.

concept in contrast to strict legal liability. This is similar to the idea of notional expenditure supported by Ger.

The supreme held that “Expenditure incurred” meant the undertaking of an obligation to pay or – which amounted to the same thing – the actual incurral of a liability.²³³ The seller did not incur expenditure in fact or law by accepting a lesser purchase price than he would have been entitled to had he not transferred the contingent liabilities to the purchaser.²³⁴

Jansen van Rensburg argues that this case provides authority by implication for holding that where a taxpayer is giving up the opportunity to earn money, no asset would be expended and no expenditure would exist.²³⁵ A diminution of an asset in the strict legal sense is required.

The researcher agrees that this is a possible implication of *Ackermans*, but sight should not be lost of the context within which the case was decided.

Ackermans firstly preceded *Labat*, and as such the court did not address ‘expenditure’ in isolation as a distinct requirement apart from ‘actually incurred’. The court rather addressed the whole phrase. The court found that no obligation was incurred by *Ackermans*, which as we saw in chapter 4 is the requirement for ‘actually incurred’. This was traditionally pre-*Labat* the test to determine whether expenditure was actually incurred.

Consequently one cannot deduce with certainty that the court regarded this right forgone as not constituting expenditure. It might be that they merely rejected it on the grounds that it did not create an unconditional obligation in the legal or factual sense. Nevertheless, it serves as an illustration of the courts general unwillingness to allow a deduction for foregoing the opportunity to earn monetary amounts.

5.3.5 Concluding remarks

²³³ *Ibid* para 8.

²³⁴ *Ibid* para 11.

²³⁵ Jansen van Rensburg op cit note 48 at 72.

Labat is the first case in which the Supreme Court attempts to define expenditure. The researcher agrees with Jansen van Rensburg that the court although providing an acceptable definition, failed to thoroughly define the individual building blocks of this definition. One of these is the term 'asset'. No certainty is provided by case law as to what meaning should be attributable.

On considering all the above authorities, it would seem that there is general sense that commercial expediency requires that expenditure not be restricted to a mere diminution of assets in the strict legal sense, but rather be extended to any economic sacrifices. The discussion however has also shown that our courts have been reluctant to allow the deduction for the loss of income earning possibilities. The researcher accordingly contends that it would be highly unlikely to succeed on the right forgone argument in future. A diminution as assets in the legal sense would be required on the basis of *Labat*.

5.4 Set-off as a possible method of payment

5.4.1 The Argument

This argument was first raised by Meyerowitz, writing on share-based payments.²³⁶ He based his argument on the old companies act requirements as regards the issue of shares.²³⁷ Namely shares could not be issued at less than par value, and only once consideration had been received in full. On these principles the author held that where a company receives assets or services in place of cash, the company has by set-off expended an amount equal to the nominal value of the shares. He supports his argument with approval of the English authorities as we have previously discussed in paragraph 2.2.2.

Meyerowitz concludes in linking this set-off argument to that of an 'economic equivalence contention'. The effect of share-based payments (as found in *Labat*) is the same to the situation had the company first paid for the services/assets, and then the opposite party had applied these funds in acquiring the shares. This economic equivalence argument was rejected by *Labat*.²³⁸ Our courts give effect to the transaction as entered into on its legal nature, and not on the basis of what could have been structured differently using a different legal form to achieve the same economic consequences.²³⁹

5.4.2 Theoretical background

Set-off occurs where two parties have claims against each other. Where the requirements for set-off are met, the claims can be extinguished against each other. The following four requirements need to be complied with for set-off to occur.²⁴⁰

i) The debts must exist between the same two parties acting in the same capacity. ii) The debts must be of the same type or nature. iii) Both debts

²³⁶ DM op cit note 104 at 87.

²³⁷ See ss81, 82 and 92 of the old companies act. See also the discussion on shares in section 1.3 where the equivalent sections in the new act are addressed.

²³⁸ *Labat* supra note 8 par 15.

²³⁹ Jansen van Rensburg op cit note 48 at 62.

²⁴⁰ D Hutchison (ed), CJ Pretorius (ed) & J Du Plessis et al *Kontraktereg in Suid-Afrika* (2010) at 398-399.

must be enforceable. The debts should not be subject to any conditions, time clauses or a possible defence of *exceptio non adimpleti contractus*. This defence entails that the party from which performance is claimed, can object on the basis that the opposite party has not performed his part of the contract (defeasible duty to perform).²⁴¹ iv) Both debts should be liquid in nature. This entails that the debt should be capable of easy and speedy proof.

For purposes of our discussion as regards share-based and service based payments, we will focus on (ii) and (iii).

5.4.3 Application on the facts of *Labat* and others.

If one takes the *Labat* facts as a starting point, it is clear that set-off would not be possible, as the debts are not similar. *Labat* had an obligation to issue shares, whereas the opposing party had an obligation to pay a cash amount. This was confirmed by Harms AP stating: 'How one can set-off shares against money was not explained.'²⁴²

The question however becomes a bit more complicated if we tweak the facts somewhat. If we assume that the shares were issued for consideration in cash, and the trademark/asset was sold for cash. Could it be argued that the cash amounts from these two transactions can be set-off against each other?

De Cock in rejecting the possibility looks at the requirement that shares be fully paid up before they can be issued.²⁴³ He refers to *Etkind and Others v Hicor Trading Limited and another*, where the court held that consideration (cash or otherwise) should be received on or prior to shares being issued.²⁴⁴ This leads him to conclude that a share subscription agreement creates a bilateral contract between the parties.²⁴⁵ Thus the obligations created would be reciprocal, and performance of one would be conditional upon performance of the other. This creates a 'catch 22' situation in which the company cannot issue its shares prior to payment being received, but

²⁴¹ Ibid at 329.

²⁴² *Labat* supra note 8 para 15.

²⁴³ De Cock op cit note 133.

²⁴⁴ *Etkind* supra note 30.

²⁴⁵ De Cock op cit note 133 at 56-57.

conversely the allottee can withhold payment until shares are issued in terms of the *exceptio*. Thus the author concludes that the third requirement for set-off is not met.

The researcher contends that De Cock's argument could be overcome by the application of s40(5) of the new Companies Act. This section creates the possibility for a subscription agreement which provides for payment at a future date. The company is obligated to issue the shares immediately, but the shares are held in trust by a third party until such stage as the subscriber has paid up.²⁴⁶ In this scenario the subscriber would not be able to avail himself on the *exceptio*, as the shares have already been issued. There is thus an indefeasible duty to perform on the subscriber's part and the debts are both cash and thus of the same type. The requirements for set-off are consequently met.

The researcher thus contends that set-off would be possible in certain defined cases, namely where the shares are issued for consideration in cash. Further the shares although not paid up, need to be issued as provided for in terms of s40(5). If these conditions are present, the cash debts of the issuing company (as regards the asset/service acquired) can be set-off against the subscription debt due by the allottee.

Jansen Van Rensburg supports this argument in stating that set-off would be possible in the case where the contract created a duty on the company to pay the counter party in cash, and the counter party incurred an obligation to subscribe for the shares in cash.²⁴⁷ In this scenario, the cash amounts can be set-off without any cash being exchanged.

²⁴⁶ Section 40(5)(b)(ii) of act 71 of 2008.

²⁴⁷ Jansen van Rensburg op cit note 48 at 61.

5.5 Debt reduction and the possibility of recoupment, reduction in assessed losses and capital gains²⁴⁸

5.5.1 The Argument

One of the criticisms raised by Marais against *Labat*, was the anomaly it created when initial payment for an asset/share was agreed in cash, but in a subsequent year the parties agreed that consideration would take the form of shares. He states: ‘...does an expense, previously recognised, like Proteus or werewolves at the sight of the full moon, suddenly transmute into something else?’²⁴⁹

On the basis of our previous discussion on *Labat* in chapter three, we have seen that where the parties in year one agree that payment would take the form of cash, expenditure would be actually incurred, as there exists an unconditional obligation of which the hypothetical discharge would require an diminution of assets. What happens when the parties now, in year two agree on payment by share issue?

It has been argued that Marais’ anomaly could possibly be addressed by the application of ss8(4)(m), 20(1)(a)(ii) and para12(5) of the eighth schedule.²⁵⁰ Namely that instead of changing character from expenditure to non-expenditure, one could rather work with recoupment, reductions in assessed losses or capital gains, where an initial expenditure is discharged by share issue in a later year. These provisions have however all been removed by the Taxation Laws Amendment Act of 2012.²⁵¹

What follows is a review of these old provisions and the arguments based thereon. The purpose being to consider their relevance vis a vis share-based payments and whether they provided an answer to Marais’ anomaly. Additionally these provisions applied when *Labat* was considered. Thereafter the researcher will look at the new position as amended and consider in what way these have changed the old position and the impact, if any these had on share-based payments.

²⁴⁸ *CIR v Datakor Engineering (Pty) Ltd* 1998 (4) SA 1050 (SCA).

²⁴⁹ Marais op cit note 94 at 5.

²⁵⁰ See Schoon op cit note 118 at 48-56; De Cock op cit note 133 at 51-57.

²⁵¹ See s9(1)(c), s37(1) and s107(1)(c) of the Taxation Laws Amendment Act 22 of 2012.

5.5.2 Recoupment in terms of the old s8(4)(m)?

Section 8(4)(m)(i) provided as follows”

‘Subject to section 20, where as a result of...variation of an agreement or due to...waiver or release of a claim for payment, any person was during any year...relieved...from the obligation to make payment of any expenditure actually incurred; (iii) such expenditure or any allowance...was in the current or any previous year of assessment allowed as a deduction...such person shall...be deemed to have recovered or recouped an amount equal to the amount of the obligation from which the person was so relieved...’

It should be noted that this section finds application against the backdrop of s20(1)(a)(ii) which provides for reduction in assessed losses in the case of benefits received from concessions/compromises with creditors. Where an assessed loss exists, this will first be extinguished before s(8)(4) will find application. It is further more noted that recoupment is only possible where the initial obligation was allowed as deductible expenditure.

De Cock considers s8(4)(m) in the context of share-based payment for services rendered.²⁵² The following example is used: A renders services to B, and they agree that B will pay in cash. In year two, the parties agree that B will rather issue shares to A to extinguish the debt. The author contends that this is a situation where the initial agreement is amended by a second agreement in year two. This second agreement although creating an obligation to issue shares, relieves B of the initial obligation to pay cash (release from claim for payment).²⁵³ This in turn triggers s8(4)(m) and thus a recoupment.

Whether this obligation to issue shares still constitutes ‘payment’ as defined is uncertain, as the act does not define payment for purposes of the section. Dictionary definitions provide limited assistance as the following illustrates.

Payment: ‘the action or process of paying someone or something or of being paid’²⁵⁴ ; ‘Performance of an obligation by the delivery of money or

²⁵² De cock op cit note 133 at 52.

²⁵³ Ibid at 54.

²⁵⁴ Oxford dictionary op cit note 59.

some other valuable thing accepted in partial or full discharge of the obligation.’²⁵⁵

It is thus uncertain whether this amended form of consideration in the form of shares necessarily relieves B of payment, in the sense required by s8(4)(m). The second agreement could be construed as merely amending the form of payment, but not releasing B from his payment obligations.

De Cock in construing payment in a wide sense, states that payment could hypothetically occur by way of set-off, in which case recoupment would not be applicable. De Cock in considering the possibility finds that set-off would not be possible in these circumstances as it does not meet the requirements for set-off.²⁵⁶ Our previous discussion at 5.4 *supra* has however shown the contrary in certain defined circumstances. The researcher thus contends that recoupment in our example above can be avoided by way of set-off.

Nevertheless there is a sense of satisfaction to be found in De Cock’s argument as it provides a solution to the anomaly raised by Marais. If we accept that s8(4)(m) applies, the company would be regarded as recouping a taxable amount in year two equal to the expenditure it claimed in year one, without need for changing the character of the expenditure incurred in year one.

Schoon contends that s8(4)(m) could have been applied to the facts of *Labat* in which case *Labat* would have been subjected to a recoupment in the year in which relief was granted to it (namely to pay in shares).²⁵⁷ It should be noted that the authors opinion was based on the high court case, where Sapire AJ held, that the obligation to issue shares constituted expenditure actually incurred, despite the fact that no diminution in assets occurred.²⁵⁸ The mere incurrence of an obligation was sufficient.

The researcher contends that the facts of *Labat* do not necessarily create an opportunity for s8(4)(m) recoupment. As seen above what is required

²⁵⁵ BA Garner (ed), T Jackson & J Newman *Black’s Law dictionary* 8 ed (2004) at 1165.

²⁵⁶ See the discussion on set-off at 5.4.

²⁵⁷ Schoon op cit note 118 at 55.

²⁵⁸ *CSARS v Labat Africa Ltd* *supra* note 4.

for the application of s8(4)(m) is relief from an obligation to pay. On the facts of *Labat* the crucial issue was exactly the lack of such an obligation. *Labat* never incurred an obligation to pay cash, but rather to issue shares. There was thus never an obligation to pay which could be said to have been reduced. The high court held that the obligation to issue shares amounted to expenditure, despite not diminishing any assets. The court never regarded the facts as creating an initial obligation to pay in cash. In the subsequent appeal case, the court never acknowledged deductible expenditure.²⁵⁹ Thus the possibility of recoupment also not existed on Harms AP's interpretation as one can only recoup something which has previously been allowed as a deduction.

Furthermore, *Labat* dealt with the acquisition of a capital asset (trademark) on which capital allowances could be claimed provided the requirements of s11(gA) were met. This being the case, the researcher contends that debt incurred on the acquisition of the trademark and subsequently waived, should rather be addressed by para 12(5) of the eighth schedule.

5.5.3 Section 20(1)(a)(ii) and the relevance of *Datakor*.

Section 20(1)(a)(ii):

'the balance of assessed loss shall be reduced by the amount or value of any benefit received...to a person resulting from a concession

²⁵⁹ *Labat* supra note 8.

granted by or a compromise made with any creditor...whereby any liability owed...to such creditor has been reduced...to the extent that (aa) the amount advanced...used...to fund expenditure or an asset; and (bb) a deduction was allowed in terms of section 11...'

Schoon argues on the basis of *Datakor*, that where a company discharges an initial cash obligation by subsequent share issue, this would amount to a compromise as required by the above mentioned section and constitutes a benefit to the company as the cash obligation is absolved.²⁶⁰ This argument is thus very similar to that of De Cock's and it is contented that the *Datakor* interpretation on s20(1)(a)(ii) also provides guidance in considering the application of s8(4)(m).

He states that by issuing shares, the company is extinguishing the creditor's right to claim cash in exchange for shares.²⁶¹ He continues in highlighting the difference between shares and a creditor's claim. A creditor can enforce his claim at any time, whereas a shareholder only has a right to share in dividends and assets at liquidation.

This is confirmed with reference to Jooste, stating as follows:

'Although the scheme alters the capital structure of the company, it enables the company to rid itself of its creditors who no longer have any claim against the company. Prior to the concession, the debtor company had to pay cash, subsequent thereto the debtor company no longer had an obligation to pay anything.'²⁶²

Jooste concludes that this compromise gives the company a clearly defined benefit in the form of the reduced claims and should consequently reduce its assessed loss.²⁶³

Further support is found in the *Datakor* case.²⁶⁴ The case concerned a company (*Datakor* Engineering) who was placed in liquidation. A scheme

²⁶⁰ Schoon op cit note 118 at 48.

²⁶¹ Ibid at 49.

²⁶² RD Jooste '*Schemes of Arrangement – a new development*' (1989) 28 *Income Tax Reporter* 7 at 10-11.

²⁶³ Ibid.

²⁶⁴ *Datakor* supra note 248.

of arrangement followed in terms of which the unpaid claims of the concurrent creditors were capitalised by the issue of redeemable preference shares to the creditors equal in value to the claims. The taxpayer then sought to carry forward its assessed loss of a previous year, to which the revenue service objected, arguing that s20(1)(a)(ii) applied.

Harms JA, as he was then, finding as follows:

‘...the mere substitution of a creditor’s claim with a share, even a redeemable preference share, amounted to a concession. An enforceable obligation was replaced with something of a completely different nature. In the case of debts, all the assets of the company were available to satisfy the claims of creditors whereas, in the case of redeemable preference shares, only the profits available for dividends...The right to redeem vested in the company...’²⁶⁵

‘The concession by the creditors to waive the balance of their exigible claims against the taxpayer in return for a “right” of redemption of redeemable preference shares had of necessity to translate into a benefit to the taxpayer.’²⁶⁶

It is contented by the researcher that this statement by Harms JA, should additionally inform the s8(4)(m) inquiry as addressed above. If share-based payment in discharge of an original cash obligation would be sufficient in Harms AP opinion to trigger s20(1)(a), it would also suffice for s8(4)(m) recoupments.

Schoon contends that the principles as enunciated in *Datakor* find equal application in the *Labat* case, and that had the court considered these principles, it might have come to a different conclusion. He argues as follows:

‘...the vendor sold a trademark and agreed to accept shares in consideration. In terms of the agreement, the vendor/creditor gave up its right to demand payment in cash. This concession amounts to a compromise. As a result...purchasing company...in a better position...’²⁶⁷

Although the above statement is sound in principle, it fails to recognise the true nature of the *Labat* facts. Schoon’s argument as to the applicability of

²⁶⁵ *Ibid* para 11.

²⁶⁶ *Ibid* para 15.

²⁶⁷ Schoon op cit note 118 at 52. It should be noted that Schoon based his argument on the high court case, prior to *Labat* (SCA).

Datakor to the facts of *Labat*, would have held true, had the original agreement between *Labat* and the seller provided for cash consideration. The argument fails to recognise the fact that in the *Labat* case, the seller of the trademark never had an enforceable right to cash. As our previous discussion in chapter three has shown, there was no obligation incurred which the hypothetical discharge of, would require a diminution of assets (cash). It was this essential characteristic of the agreement that led Harms AP to concluding that there was no expenditure actually incurred on appeal. Had there been a right to claim cash, as Schoon contends is given up through compromise, expenditure would have been acknowledged on appeal.

As Schoon considered the high court case we see further that Sapire J allowed the expenditure, but never accepted that there existed an initial obligation to pay in cash. He rather argued that a diminution of assets was not required.²⁶⁸

A further clear indication that s20(1)(a) and its counterpart s8(4)(m) could not apply to the facts of *Labat* is the fact that both sections require that the amount be previously allowed as an deduction.²⁶⁹ In the *Labat* appeal court case, the obligation incurred to acquire the trademark was never allowed as a deduction in terms of section 11. Thus no recoupment could have taken place.

The researcher contends that the findings of Harms AP in *Labat* accords with his previous findings in *Datakor*. Where an initial cash obligation is incurred, Harms AP would regard this as expenditure. Where the initial obligation takes the form of shares, no expenditure exists. It is only where an initial cash obligation turns into a share obligation, that recoupment would be expected, as the initial expenditure now needs to be recovered. This also provides an acceptable solution to Marais' anomaly as addressed in the introduction to this argument.

5.5.4 Paragraph 12(5) of the eight schedule.

²⁶⁸ CSARS v Labat Africa Ltd supra note 4 at 77.

²⁶⁹ See s8(4)(m)(iii) and s20(1)(a)(ii)(bb) of the act.

It should be noted that s20(1)(a)(ii) is limited in its application. As De Koker states in *Silke*, the section will only lead to a reduction in assessed loss, where the liabilities so reduced or extinguished, has arisen in the ordinary course of trade.²⁷⁰ This means that where the liability was incurred in the acquisition of capital assets, such a reduction could be dealt with by para 12(5) of the eighth schedule, where neither s8(4)(m) or s20(1)(a)(ii) has been applied.

In terms of para 12(5), any reduction in capital debt is regarded as being acquired for no consideration and disposed of for a value equal to the reduction amount. Thus in effect a capital gain to the value of the reduction amount is realised.

Thus on the reasoning of Schoon, where a capital debt is waived in exchange for shares, the issuing company will incur a capital gain to the value of the debt so waived.²⁷¹

It should be noted that para 12(5)(a) states: ‘...where a debt owed by a person to a creditor has been reduced or discharged by that creditor – (i) for no *consideration*...’. (emphasis added)

The test applied by para 12(5) is thus one of consideration. It would seem that Harms AP regards the issue of shares as constituting ‘consideration’ when he states in *Labat*: ‘...the issue of shares for the acquisition of assets amounted to “consideration” given by the company. *This is hardly contentious*.’²⁷² It is submitted that para 12(5) would thus not be applicable to the scenario of share-based payments in discharge of a capital debt.

5.5.5 The position as amended?

²⁷⁰ *Silke* op cit note 76 para 8.129.

²⁷¹ *Schoon* op cit note 118 at 56.

²⁷² *Labat* supra note 8 para 10.

Given the recent financial crisis and the large number of local companies facing financial distress, the government regards the provision of relief to these companies as essential to local economic recovery and stability.²⁷³

Legislature's concern is visible in the new companies act. The act provides a lifejacket for companies in financial distress in the form of business rescue proceedings.²⁷⁴ Section 155 makes express provision for compromises between a company and its creditors. The problem is that the current tax system as embodied by the above mentioned provisions impedes this recovery process.²⁷⁵ Where a party receives the benefit of debt relief, the economic benefit is effectively undermined by the additional tax imposed.²⁷⁶ Consequently all three the above addressed provisions have been removed. The reduction or cancellation of debt is now governed by s19 as read with para 12A of the eight schedule. These provisions apply to all tax years starting on or after 1 January 2013.²⁷⁷

Section 19

Section 19(2): 'this section applies where a debt that is owed by a person is reduced by any amount and – (a) the amount of that debt was used, directly or indirectly, to fund any expenditure in respect of which a deduction or allowance was granted...and (b) the amount of that reduction exceeds any amount applied by that person as *consideration* for the reduction (reduction amount).' (emphasis added)

Paragraph 12A of the eight schedule.

'this paragraph applies where a debt that is owed by a person is reduced by any amount and- (a) the amount of that debt was used directly or indirectly, to fund any expenditure- (i) other than expenditure in respect of which a deduction or allowance was granted in terms of this act; or (ii) incurred in acquisition...of an allowance asset; and (b) the amount of that reduction exceeds any amount applied by that person as *consideration* for that reduction.' (emphasis added)

²⁷³ Explanatory Memorandum to 2012 act , at 44.

²⁷⁴ Chapter 6 of the companies act 71 of 2008.

²⁷⁵ Section 8(4)(m), s20(1)(a) and para12(5) of the eight schedule.

²⁷⁶ Explanatory Memorandum op cit note 43 at 44.

²⁷⁷ Section 36(2) and s108(2) of Act 22 of 2012.

The two provisions read together create a scheme in which there can be distinguished between four types of debt, each with its own rules in the case of debt reduction.

- i) *Trading Stock (not disposed of) debt*: The reduction amount should firstly reduce any s11(a) or s22(1)-(2) deduction in respect of the trading stock in the tax year.²⁷⁸ Should the reduction amount exceed this, the excess should be regarded as a recoupment in terms of s8(4)(a).²⁷⁹
- ii) *Expenditure allowed as a deduction/allowance other than (a) expenditure incurred in the acquisition of trading stock not disposed of; (b) expenditure incurred in acquisition of allowance asset*: Reduction amount be deemed to be recouped to the extent that a deduction/allowance was granted.²⁸⁰
- iii) *Expenditure incurred in the acquisition/creation/improvement of an allowance asset*: The reduction amount will firstly reduce the expenditure for purposes of para20 of the eighth schedule (base cost reduction).²⁸¹ Should the reduction amount exceed the base cost, the excess will be regarded as an recoupment in terms of s8(4)(a).²⁸²
- iv) *Expenditure incurred in the acquisition/creation/improvement of an asset (other than an allowance asset)*: Where the asset is still held, the reduction amount will first be used to reduce the base cost expenditure for purposes of para20.²⁸³ The excess reduction amount will be applied in reducing the assessed capital loss.²⁸⁴ Where the asset is no longer held, the whole reduction amount will be used to reduce the assessed capital loss.

The new provisions expressly exclude certain debt reductions. These include reductions as part of a bequest from an estate, reductions that

²⁷⁸ Section 19(3)(b).

²⁷⁹ Section 19(4)(c).

²⁸⁰ Section 19(5).

²⁸¹ Paragraph 12A(3)(b).

²⁸² Section 19(6)(b)(ii).

²⁸³ Paragraph 12A(3)(b).

²⁸⁴ Paragraph 12A(4)(b).

constitute a donation and finally reductions that form a disguised salary (employer-employee relationship).²⁸⁵

5.5.6 Concluding remarks

The new scheme as embodied by the above provisions looks to be more attractive to taxpayers subjected to debt reductions. This can be seen from the additional exclusions, but also from the change in approach in comparison to the old sections. Recoupments can now be reduced by firstly diminishing them against other expenditure and base cost whereas previously the whole reduction amount was merely regarded as constituting either a capital gain or revenue recoupment. This would seem to be in accordance with government's aims in supporting economic recovery and stability.

However a further important consideration brought about by the new amendments should be noted. The old provisions phrased the reduction amount as a 'reduction/relief from liability/obligation to make payment'. It was argued that these provisions could be construed as including share-based payments of initial cash obligations in the sphere of debt reduction.²⁸⁶ Namely where shares are issued in discharging a cash debt, the issuing company receives relief from the obligation to make payment.

The new provisions however define the reduction amount as follows: '...means any amount by which that debt is reduced less any amount applied by that person as consideration for that reduction.'²⁸⁷ As our previous discussion has shown, Harms AP regarded share-based payments as constituting consideration.²⁸⁸ This position is supported by English case law as discussed in 3.3 supra.

It is consequently submitted by the researcher, that where a company discharges an initial cash debt by the issue of shares, this would not be

²⁸⁵ Section 19(8) and para12A(6)(a)-(c) of the eight schedule.

²⁸⁶ See De cock op cit note 133, Schoon op cit note 118 as read with *Datakor* supra note 248.

²⁸⁷ Section 19(1) and para12A(1) of the eight schedule: 'reduction amount' as defined.

²⁸⁸ Labat supra note 8 para 10.

regarded as a debt reduction as conveyed by s19 and para12A as the company still gives 'consideration' for the reduction. Thus no recoupment, reduction in assessed loss or capital gain will arise.

This interpretation would also be in accordance with SARS' aims of economic recovery and stability by providing tax relief to financially distressed companies. The conversion of debt to equity is a common practice involved in business rescue and by regarding this as a recoupment; SARS would once again be impeding the workings of chapter six of the new companies act.

Chapter 6 Conclusion

6.1 In summary

The primary aim of this study was to determine the meaning of ‘expenditure actually incurred’ as contained in the act and whether share-based payments could be regarded as such. Once this had been ascertained, the study would then consider the appropriateness of this meaning by considering the most pertinent arguments on the topic.

6.1.1 Relevance of ‘expenditure actually incurred’

The researcher found that the phrase finds application in a variety of sections throughout the act, and that its true meaning is thus of considerable importance. As regards to share-based payments, the meaning still remains relevant where s40CA and s11(IA) do not find application.

6.1.2 The meaning of expenditure

The study found that ‘expenditure’ adds the requirement of a diminution or at least a movement of assets post *Labat*. The mere incurrence of an obligation would not be regarded as expenditure. ‘Expenditure’ effectively requires that the nature of the obligation be of such a nature that its discharge would lead to a movement of assets.

6.1.3 The meaning of actually incurred

The study found that the existing position as regards ‘actually incurred’ remains intact post *Labat*. Thus what is required is the incurrence of an unconditional obligation. Expenditure cannot be actually incurred before such an obligation exists. *Labat* merely circumscribes the nature of the obligation incurred, namely that its discharge would require a movement of assets. There is no requirement post-*Labat* that the obligation should already be paid.

6.1.4 Diminution/movement of assets or a mere obligation

The study found both primary and secondary sources on this question prior to *Labat*, to be contradictory. One group supporting the argument that

a mere obligation should suffice, relying on 'actually incurred' case law. The other group arguing for a diminution of assets at the hand of a strict literal approach. The researcher contends that *Labat* is correct in requiring that expenditure requires something apart from the mere incurrence of an obligation as required by 'actually incurred'.

The researcher however disagrees with *Labat's* interpretation given to 'expenditure' which requires a movement of assets. The researcher contends that expenditure should rather be defined on the basis of what gives rise to the obligation or movement of assets. The fact that the expenditure is incurred by way of either an increase in liability or reduction in assets is irrelevant; these are merely two sides of the same coin.

6.1.5 Right forgone Argument

The study showed that where a company issues shares as fully paid up, it does not part with an asset in the legal sense. At most what is given up is a *spes*, which is not regarded as enforceable in law. As regards the argument that asset diminution for purposes of expenditure should be interpreted in a broader manner than the strict legal sense to include any economic sacrifices, such an argument is found to be unlikely considering recent case law. It is concluded that a diminution of assets in the legal sense is required and that share-based payments do not constitute such.

6.1.6 Set-off

It is found that set-off as a possible method payment which would constitute expenditure actually incurred, would only be possible in the case where the shares are initially issued for cash in terms of s40(5) of the new companies act. In such circumstances the cash debts can be set-off against each other.

6.1.7 Debt reduction where shares are issued to settle cash debt?

The study has found that where shares are issued in discharge of an initial cash debt, the old s8(4)(m) and s20(1)(a)(ii) could possibly apply on the reading of the *Datakor* case. The issuing company could consequently be

subject to recoupment and reductions in assessed loss. It was further contended that these sections should not have found application in the case of *Labat*, as no expenditure was actually incurred. Finally the impact of the new Taxation Laws Amendment Act was considered. It was found that the new provisions regulating debt reduction would no longer encompass share-based payments of previous cash debts under its scope.

6.2 Share-based payments: The path going forward and practical alternatives to the problem

The position post-*Labat* is that share-based payments would not be regarded as expenditure actually incurred. Where the shares are issued in the acquisition of assets, one could apply s40CA in which case expenditure would be deemed to have been incurred equal to market value of the shares issued. Where s40CA however does not apply, alternative methods need to be followed to insure a deduction.

i) Issuing shares for cash and applying the proceeds towards the relevant expense.

This would be the safest route to follow. There exists a clear money trail which would constitute the required diminution/movement of assets upon incurrence of the expenditure.

ii) Buy the services/asset on credit, and later settle the obligation by issuing shares.

This option would be regarded as expenditure in terms of *Labat*, as it involves the incurrence of an initial obligation which the hypothetical settlement of would require a movement of assets (cash). The risk associated with taking this route is that SARS could possibly argue substance over form given cash never flows.²⁸⁹ Another risk is the possibility of SARS arguing debt reduction on the basis of *Datakor*, and arguing for recoupment in terms of s19 of the act. The researcher however argues this would not be possible on a reading of s19.

Alternatively the issuing company can issue the shares for

²⁸⁹ Brincker op cit note 2 at p-4.

consideration in cash, and set-off this right to claim cash against its cash obligation originally incurred.

iii) Issue the shares directly as consideration for services/asset, thus no cash obligation even arises.

This is similar to the facts of *Labat*. No expenditure would be incurred, unless s40CA applies.

iv) Company pays cash as consideration and seller has option to acquire shares in company.

This is once again a scenario where the company clearly departs with an asset at acquisition and expenditure would be regarded to have been incurred.

v) Company pays cash as consideration and seller is obligated to use funds to acquire shares in said company.

This would constitute expenditure actually incurred as a diminution of assets occurs. This alternative poses some risk as SARS could possibly argue substance over form. To prevent such a situation, it is important that the cash amount actually flows through and that a time delay exists between receipt of the cash by the seller and subsequent share subscription.²⁹⁰ What should be clear is an intention to transfer and retransfer the cash.

²⁹⁰ Ibid.

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